12 Am. Jur. 2d Bills and Notes XII A Refs.

American Jurisprudence, Second Edition | May 2021 Update

Bills and Notes

Lonnie E. Griffith, Jr., J.D.; Sonja Larsen, J.D.; Lucas Martin, J.D.; Karl Oakes, J.D.; Eric C. Surette, J.D.; and Barbara J. Van Arsdale, J.D.

XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

Topic Summary | Correlation Table

Research References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 100 to 105, 109, 113, 115, 336.1, 342, 365(1) to 384, 452(1) to 453

A.L.R. Library

A.L.R. Index, Bills and Notes
A.L.R. Index, Checks and Drafts
West's A.L.R. Digest, Bills and Notes 100 to 105, 109, 113, 115, 336.1, 342, 365(1) to 384, 452(1) to 453

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12 Am. Jur. 2d Bills and Notes § 494

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 494. Defenses and claims in recoupment in action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 365(1)

A.L.R. Library

Validity, in contract for installment sale of consumer goods, or commercial paper given in connection therewith, of provision waiving, as against assignee, defenses good against seller, 39 A.L.R.3d 518

Transferee of commercial paper given by purchaser of chattel and secured by conditional sale, retention of title, or chattel mortgage, as subject to defenses which chattel purchaser could assert against seller, 44 A.L.R.2d 8

Treatises and Practice Aids

As to defenses and claims in recoupment, generally, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to defenses, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Forms relating to defenses, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code; Uniform Commercial

Code Pleading and Practice Forms, Article 3 Negotiable Instruments [Westlaw®(r) Search Query]

A distinction is made between defenses and claims in recoupment that may be raised against any plaintiff and those that may not be asserted against a plaintiff who has the rights of a holder in due course.[1] Where an obligor has a defense or claim in recoupment, the holder's right to recover on the instrument depends upon whether he or she has the rights of a holder in due course.[2] If an instrument is negotiable and the obligee is a holder in due course, the obligee's right to enforce the obligation of a party to pay the instrument is subject only to certain enumerated "real" defenses and to claims in recoupment stated against the obligee.[3] If the instrument is negotiable but the obligee does not have the rights of a holder in due course, the right to enforce the obligation of a party to pay the instrument is also subject to all claims in recoupment and to certain defenses which constitute the so-called "personal" defenses.[4] Thus, unless one has the rights of a holder of a note in due course, he or she is subject to all the defenses of any party which would be available in an action on a simple contract.[5]

Caution:

The provision of the Uniform Commercial Code governing defenses and claims in recoupment that can be asserted by an obligor against a person attempting to enforce a negotiable instrument applies only to actions to enforce the obligation of a party to pay an instrument.[6]

An ordinary holder of commercial paper is subject to any defense held by the defendant.[7] Thus, when the payee of a teller's check is an ordinary holder, it is subject to any defense held by the customer who has intervened as a defendant in the payee's action against the drawer.[8]

Caution:

In a consumer transaction, if law other than Revised Article 3 requires an instrument to contain a statement regarding the rights of a holder or transferee are subject to a claim or defense that the issuer could assert against the original payee, and the instrument does not include such statement, claims and defenses can be asserted as though the instrument contained the statement.[9]

Footnotes

1 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:2 (3d ed.).

2 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:3 (3d ed.).

3 U.C.C. § 3-305(b) [2002].
As to holders in due course, generally, see § 208.
As to the requirements for a holder of an instrument to qualify as a holder in due course, see §§ 214 to 270.

As to the rights of a holder in due course, generally, see § 232.
As to real defenses, generally, see § 496.
As to claims in recoupment, see §§ 561 to 564.

[4] U.C.C. § 3-305(a) [2002].
As to personal or limited defenses, generally, see § 497.
As to holders not in due course, generally, see § 208.
As to the effect upon defenses by the holder-in-due-course status, see § 495.

[5] Walker v. Probandt, 25 Neb. App. 30, 902 N.W.2d 468, 93 U.C.C. Rep. Serv. 2d 838 (2017), review denied, (May 8, 2018) and cert. denied, 139 S. Ct. 333, 202 L. Ed. 2d 223 (2018).
Unless a foreclosing party can establish itself as a "holder in due course" of a promissory note, it will be considered a "holder" subject to all of an opposing party's affirmative defenses. Nationstar Mortgage LLC v. Kanahele, 144 Haw. 394, 443 P.3d 86 (2019).

[6] Thompkins v. Mortgage Lenders Network USA, Inc., 209 Md. App. 685, 61 A.3d 829, 79 U.C.C. Rep. Serv. 2d 768 (2013), judgment aff'd, 439 Md. 118, 94 A.3d 61, 83 U.C.C. Rep. Serv. 2d 1026 (2014).

[7] J.P. Morgan Delaware v. Onyx Arabians II, Ltd., 825 F. Supp. 146 (W.D. Ky. 1993); Cadle Co. v. Bankston & Lobingier, 868 S.W.2d 918 (Tex. App. Fort Worth 1994), writ denied with per curiam opinion, 893 S.W.2d 949 (Tex. 1994); Wesche v. Martin, 64 Wash. App. 1, 822 P.2d 812, 17 U.C.C. Rep. Serv. 2d 510 (Div. 1 1992).

[8] Guaranty Federal Sav. Bank v. Horseshoe Operating Co., 793 S.W.2d 652, 11 U.C.C. Rep. Serv. 2d 571 (Tex. 1990).

[9] U.C.C. § 3-305(e) [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 495. Holder-in-due-course status as cutting off defenses in action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 365(1)

A.L.R. Library

Duress, Incapacity, Illegality, or Similar Defense Rendering Obligation a Nullity as Affecting Enforceability of Negotiable Instrument Against Holder in Due Course Under U.C.C. [rev] s3-305(a)(1)(ii), 89 A.L.R.5th 577

What constitutes "dealing" under U.C.C. sec. 3-305(2), providing that holder in due course takes instrument free from all defenses of any party to instrument with whom holder has not dealt, 42 A.L.R.5th 137

Transferee of commercial paper given by purchaser of chattel and secured by conditional sale, retention of title, or chattel mortgage, as subject to defenses which chattel purchaser could assert against seller, 44 A.L.R.2d 8

Treatises and Practice Aids

As to defenses and claims in recoupment, generally, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to holder in due course, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes

[Westlaw®(r): Search Query]

Forms relating to defenses and holder in due course, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

The right of a holder in due course to enforce the obligation of a party to pay the instrument is subject to so-called real defenses set forth by statute, but is not subject to the defense stated elsewhere in Article 3 or a defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing the right to payment under a simple contract, or claims in recoupment against a person other than the holder.[1]

Observation:

Because the primary importance of the concept of holder in due course is with respect to assertion of defenses or claims in recoupment, and of claims to the instrument, where the obligor is the only obligor on the note, the holder-in-due-course doctrine is irrelevant in determining rights between the obligor and obligee with respect to the instrument because the obligor retains its defenses against the obligee.[2]

A holder in due course is insulated from disputes arising between the original parties to a note, with certain limited exceptions.[3] A holder in due course takes a negotiable instrument free from all claims and all defenses of any party to the instrument with whom the holder has not dealt unless a defense that bars recovery by a holder in due course applies.[4] Holders in due course of a negotiable instrument are immunized from certain personal defenses generally available to the maker of the instrument.[5]

It must be remembered that a holder or transferee may have the rights of a holder in due course even though he or she does not, in his or her own right, qualify as a holder in due course. Since a transferee obtains all of the rights of the transferor, a transferee of a holder in due course takes free of the same claims in recoupment and defenses that the transferor/holder in due course would take free of.[6] A holder through a holder in due course has all the rights of that holder in due course.[7] When the holder in due course deals directly with the defendant, the holder in due course is subject to every defense of the defendant, and a subsequent holder through such a holder in due course is also subject to all defenses of the defendant.[8]

Footnotes

1 U.C.C. § 3-305(b) [2002], referring to U.C.C. §§ 3-305(a)(1) to (3) [2002]
As to real defenses, see § 496.
As to personal or limited defenses, see § 497.
As to claims in recoupment, see §§ 561 to 564.

2 Pitman Place Development, LLC v. Howard Investments, LLC, 330 S.W.3d 519 (Mo. Ct. App. E.D. 2010).

3 Erkins v. Alaska Trustee, LLC, 265 P.3d 292 (Alaska 2011).

4 RR Maloan Investments, Inc. v. New HGE, Inc., 428 S.W.3d 355, 83 U.C.C. Rep. Serv. 2d 311 (Tex. App. Houston 14th Dist. 2014).

5 Bank of New York Mellon v. Lopes, 2014-NMCA-097, 336 P.3d 443, 84 U.C.C. Rep. Serv. 2d 180 (N.M. Ct. App.

2014).

[6] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:3 (3d ed.), referring to U.C.C. § 3-203(b) [2002].
As to holders in due course, generally, see § 208.
As to the requirements for a holder of an instrument to qualify as a holder in due course, see §§ 214 to 270.

[7] Federal Deposit Ins. Corp. v. Russo, 89 A.D.2d 575, 452 N.Y.S.2d 231, 34 U.C.C. Rep. Serv. 599 (2d Dep't 1982), order aff'd, 58 N.Y.2d 929, 460 N.Y.S.2d 532, 447 N.E.2d 81 (1983); Miller v. Diversified Loan Service Co., 181 W. Va. 320, 382 S.E.2d 514 (1989).

[8] Great Western Bank and Trust Co. v. Pima Sav. and Loan Ass'n, 149 Ariz. 364, 718 P.2d 1017, 2 U.C.C. Rep. Serv. 2d 532 (Ct. App. Div. 2 1986); Manufacturers Hanover Trust Co. v. Robinson, 157 Misc. 2d 651, 597 N.Y.S.2d 986, 20 U.C.C. Rep. Serv. 2d 993 (Sup 1993).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 496. Real defenses in action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 100 to 105, 365(1), 366 to 384, 452(1) to 452(4)

A.L.R. Library

Duress, Incapacity, Illegality, or Similar Defense Rendering Obligation a Nullity as Affecting Enforceability of Negotiable Instrument Against Holder in Due Course Under U.C.C. [rev] s3-305(a)(1)(ii), 89 A.L.R.5th 577

Treatises and Practice Aids

As to defenses and claims in recoupment, generally, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to holder in due course, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Forms relating to defenses and holder in due course, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

All persons, whether or not having the rights of a holder in due course, take instruments subject to the real defenses.[1] The interest in protecting the obligor in these situations outweighs the interest in the negotiability of instruments.[2]

With respect to the real defenses, the right to enforce the obligation of a party to pay an instrument is subject to a defense of the obligor based on the following:

- infancy of the obligor to the extent it is a defense to a simple contract[3]
- duress, lack of legal capacity, or illegality of the transaction which, under other law, nullifies the obligation of the obligor[4]
- fraud that induced the obligor to sign the instrument with neither knowledge nor reasonable opportunity to learn of its character or its essential terms[5]
- discharge of the obligor in insolvency proceedings[6]

Duress, lack of legal capacity, or illegality of the transaction may be raised against any holder if such infirmity nullifies the obligation of the obligor. The Code speaks in terms of "nullifies" the obligation of the obligor. This requires that the obligation be considered "void" under the applicable law. If the obligation is merely rendered "voidable," the defenses of lack of capacity, duress, or illegality cannot be asserted against a holder in due course.[7]

The requirements for qualifying as a holder in due course include taking the instrument without notice of any claim to the instrument,[8] and without notice that any party has a defense or claim in recoupment.[9]

Footnotes

1 Cadle Co., Inc. v. Wallach Concrete, Inc., 1995-NMSC-039, 120 N.M. 56, 897 P.2d 1104, 27 U.C.C. Rep. Serv. 2d 518 (1995), referring to U.C.C. § 3-305(a)(1).

2 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:5 (3d ed.).

3 U.C.C. § 3-305(a)(1)(i) [2002].
As to infancy as a defense, see § 512.

4 U.C.C. § 3-305(a)(1)(ii) [2002].
As to lack of legal capacity as a defense, see § 513.
As to illegality as a defense, see §§ 515 to 525.
As to duress as a defense, see §§ 550, 551.

5 U.C.C. § 3-305(a)(1)(iii) [2002].
As to fraud as a defense, generally, see §§ 515 to 525.

6 U.C.C. § 3-305(a)(1)(iv) [2002].
As to a defense of an obligor based on discharge of the obligor in insolvency proceedings, see § 553.

7 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:7 (3d ed.).

8 U.C.C. § 3-302(a)(2)(v) [2002], referring to U.C.C. § 3-306 [2002].
As to the requirements for a holder of an instrument to qualify as a holder in due course, generally, see §§ 214 to 270.

9 U.C.C. § 3-302(a)(2)(vi) [2002], referring to U.C.C. § 3-305(a) [2002].
Knowledge that a check is postdated, by itself, does not give notice of the payor's defense or claim to the check. RR Maloan Investments, Inc. v. New HGE, Inc., 428 S.W.3d 355, 83 U.C.C. Rep. Serv. 2d 311 (Tex. App. Houston 14th Dist. 2014).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 497. Personal or limited defenses in action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 102, 103(1), 103(2), 109, 365(1), 366 to 384

A.L.R. Library

Validity, in contract for installment sale of consumer goods, or commercial paper given in connection therewith, of provision waiving, as against assignee, defenses good against seller, 39 A.L.R.3d 518

Transferee of commercial paper given by purchaser of chattel and secured by conditional sale, retention of title, or chattel mortgage, as subject to defenses which chattel purchaser could assert against seller, 44 A.L.R.2d 8

Treatises and Practice Aids

As to defenses and claims in recoupment, generally, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Except as otherwise provided, the right to enforce the obligation to pay an instrument is subject to a defense of the obligor stated elsewhere in Revised Article 3 or a defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract.[1]

Apart from the real defenses, Revised Article 3 states other defenses that are cut off by a holder in due course. These defenses comprise those specifically stated in Revised Article 3 and those based on common-law contract principles.[2] These Revised Article 3 defenses are:

• nonissuance of the instrument, conditional issuance, and issuance for a special purpose[3]
• failure to countersign an instrument[4]
• modification of the obligation by a separate agreement[5]
• payment that violates a restrictive indorsement[6]
• instruments issued without consideration or for which promised performance has not been given[7]
• breach of warranty when a draft is accepted[8]

The most prevalent common-law defenses are fraud, misrepresentation, or mistake in the issuance of the instrument. In most cases, the holder in due course will be an immediate or remote transferee of the payee of the instrument. In most cases, the holder-in-due-course doctrine is irrelevant if defenses are being asserted against the payee of the instrument, but in a small number of cases the payee of the instrument may be a holder in due course.[9]

Footnotes

1 U.C.C. § 3-305(a)(2) [2002].

2 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. § 3-105(a)(2), (b) [2002].

3 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. § 3-105(b) [2002].
As to nonissuance of an instrument, conditional issuance, and issuance for a special purpose as defenses, see §§ 509, 510.

4 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. § 3-106(c) [2002].
As to the failure to countersign as a defense, see § 555.

5 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. § 3-117 [2002].
As to a modification of an obligation by a separate agreement as a defense, see § 557.

6 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. § 3-206(f) [2002].
As to a payment that violates a restrictive indorsement, see § 558.

7 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. § 3-303(b) [2002].
As to want, failure, or illegality of consideration as a defense, generally, see §§ 504 to 508.

8 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. § 3-417(b) [2002].
As to breach of warranty as a defense, see § 559.

9 Official Comment 2 to U.C.C. § 3-305 [2002].
As to a payee of an instrument qualifying as a holder in due course, see § 221.
As to fraud as defense, see §§ 515 to 525.
As to mistake, see § 552.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 498. Third-party defense or recoupment in action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 115, 453

Except as provided with respect to accommodation parties, in an action to enforce the obligation of a party to pay the instrument, the obligor may not assert against the person entitled to enforce the instrument a defense, claim in recoupment, or claim to the instrument of another person.[1] It applies principally to cases in which an obligation is paid with the instrument of a third person.[2]

The general rule stated above has three exceptions. First, it is subject to the provision permitting an accommodation party to assert against the person entitled to enforce the instrument most of the defenses or claims in recoupment that could be asserted by the accommodated party.[3] Second, the other person's claim to the instrument may be asserted by the obligor, if the other person is joined in the action and personally asserts the claim against the person entitled to enforce the instrument.[4] Third, an obligor is not obliged to pay the instrument, if the person seeking enforcement of the instrument does not have rights of a holder in due course and the obligor proves that the instrument is a lost or stolen instrument.[5]

Comment:

This provision allows the issuer of an instrument such as a cashier's check to refuse payment in the rare case in which the issuer can prove that the instrument is a lost or stolen instrument and the person seeking enforcement does not have rights of a holder in due course.[6]

Footnotes

1 U.C.C. § 3-305(c) [2002], referring to U.C.C. §§ 3-305(d), 3-306 [2002].
As to defenses, generally, see §§ 504 to 560.
As to claims in recoupment, see §§ 561 to 564.

2 Official Comment 4 to U.C.C. § 3-305 [2002].

3 U.C.C. § 3-305(c) [2002], referring to U.C.C. § 3-305(d) [2002].
As to the right of an accommodation party to assert a defense, see § 499.

4 U.C.C. § 3-305(c) [2002].

5 U.C.C. § 3-305(c) [2002].
As to the defense of theft or loss of instrument, see § 549.

6 Official Comment 4 to U.C.C. § 3-305 [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 499. Defenses available to accommodation party in action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 101, 115, 453

In an action to enforce the obligation of an accommodation party to pay an instrument, the accommodation party may assert against the person entitled to enforce the instrument any defense or claim in recoupment that the accommodated party could assert against the person entitled to enforce the instrument.[1] However, the accommodation party may not assert the following defenses:

• discharge in insolvency proceedings

• infancy
• lack of legal capacity[2]

The accommodation party also may not raise the following as a defense:

• any Statute of Frauds
• whether or not the accommodation party receives consideration for the accommodation[3]

Comment:

The Uniform Commercial Code equates the obligation of the accommodation party to that of the accommodated party. The accommodation party can assert whatever defense or claim the accommodated party had against the person enforcing the instrument. The only exceptions are discharge in bankruptcy, infancy, and lack of capacity. The same rule does not apply to an indorsement by a holder of the instrument in negotiating the instrument. The indorser, as transferor, makes a warranty to the indorsee, as transferee, that no defense or claim in recoupment is good against the indorser. Thus, if the indorsee sues the indorser because of dishonor of the instrument, the indorser may not assert the defense or claim in recoupment of the maker or drawer against the indorsee.[4] The provision governing defenses that may be raised by an accommodation party must be read in conjunction with the provision which establishes rules (usually referred to as suretyship defenses) for determining when the obligation of an accommodation party is discharged, in whole or in part, because of some act or omission of a person entitled to

enforce the instrument. To the extent a rule stated in the section on suretyship defenses is inconsistent with a rule stated in the section on defenses that may be raised by an accommodation party, the rule from the section on suretyship defenses governs. For example, the provision on suretyship defenses provides rules for determining when and to what extent a discharge of the accommodated party will discharge the accommodation party. Discharge of the accommodated party is normally part of a settlement under which the holder of a note accepts partial payment from an accommodated party who is financially unable to pay the entire amount of the note. If the holder then brings an action against the accommodation party to recover the remaining unpaid amount of the note, the accommodation party cannot use this provision to nullify the suretyship defenses by asserting the discharge of the accommodated party as a defense. On the other hand, suppose the accommodated party is a buyer of goods who issued the note to the seller who took the note for the buyer's obligation to pay for the goods. Suppose the buyer has a claim for breach of warranty with respect to the goods against the seller and the warranty claim may be asserted against the holder of the note. The warranty claim is a claim in recoupment. If the holder and the accommodated party reach a settlement under which the holder accepts payment less than the amount of the note in full satisfaction of the note and the warranty claim, the accommodation party could defend an action on the note by the holder by asserting the accord and satisfaction under this provisions. There is no conflict with the suretyship defenses because that provision is not intended to apply to settlement of disputed claims.[5]

Footnotes

1 U.C.C. § 3-305(d) [2002], referring to U.C.C. § 3-305(a) [2002].

2 U.C.C. § 3-305(d) [2002].
As to the real defenses that may be raised against a party seeking to recover on an instrument, see § 496.
As to the defense of discharge in insolvency proceedings, see § 553.
As to claims in recoupment, see §§ 561 to 564.
As to the defense of infancy, see § 512.
As to the defense of lack of legal capacity, see § 513.

3 U.C.C. § 3-419(b) [2002].
As to accommodation parties, generally, see §§ 420 to 438.

4 Official Comment 5 to U.C.C. § 3-305 [2002], referring to U.C.C. § 3-416(a)(4) [2002].

5 Official Comment 5 to U.C.C. § 3-305 [2002], referring to U.C.C. §§ 3-604, 3-605 [2002].
As to the discharge of accommodation parties, generally, see §§ 366 to 385.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 500. Negligence as precluding defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 115, 365(1)

Under the common-law, it was a maxim that when a loss is sustained that must be borne by one of two innocent parties, it will fall on the party whose acts occasioned it, though that party may be free from actual fault, especially where the loss occurs because of a negligent reposing of undue confidence in another.[1] Where negligence is found on both sides, the loss may be placed on the party with the greater fault; thus, as between one who reasonably relied on an attorney and entrusted the attorney with negotiable paper, only to have the attorney forge an indorsement and transfer the paper, and the person who purchased the paper for a grossly inadequate sum and who knew of the attorney's past trickery, equity favors the former.[2] This latter principle has been given statutory recognition in the Uniform Commercial Code provision to the effect that an unauthorized signature, including a forgery, is ineffective as that of the person whose name is signed unless that person ratifies it.[3]

Observation:

As a general proposition, the Uniform Commercial Code represents an attempt to adjust the risk of loss in commercial matters in a fair and equitable manner not based on fault, but on allocating responsibility to the party best able to prevent the loss by the exercise of care, with the objective of promoting certainty and predictability in commercial transactions.[4]

Footnotes

[1] Nordin v. First Trust & Sav. Bank of Pasadena, 118 Cal. App. 697, 6 P.2d 92 (3d Dist. 1931).

[2] Berger v. Steiner, 72 Cal. App. 2d 208, 164 P.2d 559 (2d Dist. 1945).

[3] U.C.C. § 3-403(a) [2002].
As to unauthorized signatures, generally, see §§ 526 to 534.
As to the principles regarding negligence that substantially contributes to an alteration or an unauthorized signature, see §§ 542 to 548.

[4] Putnam Rolling Ladder Co., Inc. v. Manufacturers Hanover Trust Co., 74 N.Y.2d 340, 547 N.Y.S.2d 611, 546 N.E.2d 904, 10 U.C.C. Rep. Serv. 2d 14 (1989).

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12 Am. Jur. 2d Bills and Notes § 501

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 501. Estoppel as precluding defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 113, 365(2), 452(1)

A.L.R. Library

Estoppel of obligor to assert against transferee of conditional sales contract, instalment improvement or repair contract, or related commercial paper, defenses or equities available against transferor, 44 A.L.R.2d 196

Forms

Forms relating to estoppel, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Among the equitable doctrines preserved by the Uniform Commercial Code, except to the extent displaced by particular Code provisions, is that of estoppel.[1] Thus, a party may be precluded from raising a defense under the Code by the principles of estoppel.[2]

Equitable estoppel is a judicial remedy by which a party may be precluded by its own act or omission from asserting a right to which it otherwise would have been entitled, or pleading or proving an otherwise important fact.[3]

Equitable estoppel would not have prevented a bank from enforcing its claims on promissory notes, absent any showing of intended deception or gross negligence on the part of the bank, that the note makers or guarantors changed their positions

prejudicially, or justifiably relied to their detriment upon any representation by the bank.[4] Similarly, the maker of a promissory note did not establish detrimental reliance from the promissory note holder's alleged statement that the note debt was completely paid off, and thus the maker did not establish the defense of equitable estoppel in the holder's action against the maker to enforce the note, even if the note accumulated interest and late fees during the period of the alleged waiver, where the maker stopped making payments on the note five months before the conversation in which the alleged statement that the note debt was paid off occurred.[5]

A party is barred from asserting that a transaction was entered into because of fraud when the party has received and accepted some benefit from the transaction.[6]

Footnotes

1 U.C.C. § 1-103(b)[2001].

2 Great Western Bank and Trust Co. v. Pima Sav. and Loan Ass'n, 149 Ariz. 364, 718 P.2d 1017, 2 U.C.C. Rep. Serv. 2d 532 (Ct. App. Div. 2 1986) (estoppel from asserting defense of failure of consideration); Alamo Bank of Texas v. Palacios, 804 S.W.2d 291 (Tex. App. Corpus Christi 1991).
As to estoppel, generally, see Am. Jur. 2d, Estoppel and Waiver §§ 1 to 182.

3 Am. Jur. 2d, Estoppel and Waiver § 27.

4 Capital City Developers, LLC v. Bank of North Georgia, 316 Ga. App. 624, 730 S.E.2d 99 (2012).

5 Cornerstone Equipment Leasing, Inc. v. MacLeod, 159 Wash. App. 899, 247 P.3d 790 (Div. 1 2011).

6 Edison Stone Corp. v. 42nd Street Development Corp., 145 A.D.2d 249, 538 N.Y.S.2d 249 (1st Dep't 1989).

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12 Am. Jur. 2d Bills and Notes § 502

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 502. Waiver as precluding defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 113, 365(2)

A.L.R. Library

Validity, in contract for installment sale of consumer goods, or commercial paper given in connection therewith, of provision waiving, as against assignee, defenses good against seller, 39 A.L.R.3d 518

Waiver was recognized as a defense against the enforcement of a negotiable instrument under pre-Code law.[1]

A waiver, according to the generally accepted definition, is the voluntary and intentional relinquishment of a known right, advantage, benefit, claim, or privilege.[2] The Uniform Commercial Code provides that, unless displaced by the particular provisions of the Code, the principles of law and equity supplement its provisions.[3]

A party may waive the right to assert a defense that would otherwise be available under the Code.[4] A broadly worded general waiver provision in a note is effective to bar the assertion of defenses on the note, except where precluded by considerations of public policy.[5]

Any fraud in inducing the execution of a note is waived when the victim knows of the fraud, makes no objection, makes payment on the note, and executes a renewal note.[6] Thus, for example, fraud is waived where a party buys a business which is misrepresented as to value, and subsequently, after taking over the business and operating it for some time, the party gives the note in suit for the balance of the purchase price with full knowledge of the fraud.[7]

Whether a note precludes a fraud in the inducement defense hinges upon the language used by the parties, and the key is whether the obligor's reliance on a proffered misrepresentation is reasonable in light of the language used in the note.[8]

A person having the ability and the opportunity to read a note that he or she signs cannot claim to have been fraudulently induced to sign the note.[9]

Whether there has been a waiver is ordinarily a question of fact for the jury,[10] although submission to the jury of the issue of waiver of a defense to an instrument is not proper where there is no evidence of waiver.[11]

Footnotes

1 Southark Trading Co. v. Pesses, 221 Ark. 612, 254 S.W.2d 954 (1952).
A matter of defense which does not render an instrument void may be waived; thus, fraud in a bill or note does not make the instrument void, but merely voidable at the option of the wronged party, and thus it may be waived, expressly or by conduct. Storrs v. Storrs, 130 Fla. 711, 178 So. 841 (1937) (decided under former law).

2 Am. Jur. 2d, Estoppel and Waiver § 183.
As to waiver, generally, see Am. Jur. 2d, Estoppel and Waiver §§ 183 to 211.

3 U.C.C. § 1-103(b)[2001].

4 Knox v. BancorpSouth Bank, 37 So. 3d 1257 (Miss. Ct. App. 2010) (defenses waived by execution of renewal note); Walker v. Probandt, 25 Neb. App. 30, 902 N.W.2d 468, 93 U.C.C. Rep. Serv. 2d 838 (2017), review denied, (May 8, 2018) and cert. denied, 139 S. Ct. 333, 202 L. Ed. 2d 223 (2018) (note provided that signer waived any defenses based on suretyship or impairment of collateral); Rugg v. O'Donnell, 159 A.D.3d 1606, 73 N.Y.S.3d 853 (4th Dep't 2018) (defenses waived by execution of mortgage consolidation, extension, and modification agreement).

5 Feldman v. Torres, 34 Misc. 3d 47, 939 N.Y.S.2d 221 (App. Term 2011).

6 Jernigan Auto Parts, Inc. v. Commercial State Bank, 186 Ga. App. 267, 367 S.E.2d 250 (1988).

7 Storrs v. Storrs, 130 Fla. 711, 178 So. 841 (1937) (decided under former law).

8 Zyskind v. FaceCake Marketing Technologies, Inc., 101 A.D.3d 550, 956 N.Y.S.2d 45 (1st Dep't 2012).
As to fraud in the inducement as a defense in an action on a negotiable instrument, see § 520.

9 Campbell v. Citizens & Southern Nat. Bank, 202 Ga. App. 639, 415 S.E.2d 193 (1992); Wood & Huston Bank v. Malan, 815 S.W.2d 454 (Mo. Ct. App. W.D. 1991).
As to fraud in the inducement, generally, see § 520.

10 Am. Jur. 2d, Estoppel and Waiver § 211.

11 Smallwood v. Singer, 823 S.W.2d 319 (Tex. App. Texarkana 1991).

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12 Am. Jur. 2d Bills and Notes § 503

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

A. In General

§ 503. Knowledge of claim or defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 336.1, 342

A holder of an instrument is a holder in due course if the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity.[1] Under this section, questions of notice are to be determined by a subjective test of actual knowledge, rather than an objective test that might involve constructive knowledge.[2]

Footnotes

1 U.C.C. § 3-302(a)(1) [2002].

2 Carrefour U.S.A. Properties Inc. v. 110 Sand Co., 918 F.2d 345, 13 U.C.C. Rep. Serv. 2d 178 (2d Cir. 1990).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

Topic Summary | Correlation Table

Research References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 54, 58, 61, 62.1, 63, 97(1) to 97(3), 101 to 104, 106, 108.1, 114, 115, 123(1) to 123(3), 132, 136, 174, 201, 228, 239, 279, 296, 326, 365(1), 366 to 370, 372 to 378, 380 to 383, 436 to 440, 452(1), 452(3), 452(4)

A.L.R. Library

A.L.R. Index, Bills and Notes
A.L.R. Index, Checks and Drafts
A.L.R. Index, Uniform Commercial Code
West's A.L.R. Digest, Bills and Notes 54, 58, 61, 62.1, 63, 97(1) to 97(3), 101 to 104, 106, 108.1, 114, 115, 123(1) to 123(3), 132, 136, 174, 201, 228, 239, 279, 296, 326, 365(1), 366 to 370, 372 to 378, 380 to 383, 436 to 440, 452(1), 452(3), 452(4)

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

1. Want, Failure, or Illegality of Consideration

§ 504. Lack of consideration as defense to action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 97(1) to 97(3), 365(1), 370, 452(3)

Under the provision making the right to enforce the obligation of a party to pay a negotiable instrument subject to the defenses stated in Article 3,[1] it is a defense that the instrument was issued without consideration or that promised performance for the instrument was not given.[2]

Definition:

"Consideration" means any consideration sufficient to support a simple contract.[3] "Consideration" for a negotiable instrument is what the obligor received for his or her obligation.[4]

Under the provision of the U.C.C. defining the rights of a holder in due course of a negotiable instrument, the defenses from which a holder in due course takes free are personal defenses, which includes failure for lack of consideration between the original parties to the negotiable instrument.[5] For example, the failure of a payee-seller to deliver goods to the buyer-drawer cannot be raised against a holder in due course of the buyer's check.[6] When trying to collect on a note where want of consideration has been raised as a defense, the purchaser must show by affirmative evidence that the note was taken for value, in good faith before maturity without notice of any defense against it.[7]

Lack[8] or failure[9] of consideration may be raised against an ordinary holder.[10]

A defendant cannot defeat the action on the ground of lack or failure of consideration and still retain any part of the consideration.[11] Further, if one comaker of a promissory note receives consideration, the other may not allege a lack or failure of consideration as a defense.[12]

Footnotes

1 U.C.C. § 3-305(a)(2) [2002].

2 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. § 3-303(b) [2002].

3 U.C.C. § 3-303(b) [2002].

4 Thomas v. Bryant, 597 So. 2d 1065, 19 U.C.C. Rep. Serv. 2d 493 (La. Ct. App. 2d Cir. 1992).

5 Oupac, Inc. v. Sam, 89 So. 3d 402 (La. Ct. App. 3d Cir. 2012); General Credit Corp. v. New York Linen Co., Inc., 46 U.C.C. Rep. Serv. 2d 1055 (N.Y. City Civ. Ct. 2002).
A payor's nonreceipt of consideration from the payee when she wrote a check on her account in part payment of a debt owed to the payee by a third-party debtor was not a defense to the check, where the payee qualified as a holder in due course. Silverberg v. Mirenberg, 192 Misc. 2d 563, 746 N.Y.S.2d 742 (N.Y. City Civ. Ct. 2001).

6 DeVerna v. Kinney Systems, Inc., 146 Misc. 2d 276, 556 N.Y.S.2d 190 (App. Term 1990).

7 Hunt v. NationsCredit Financial Services Corp., 902 So. 2d 75 (Ala. Civ. App. 2004).

8 Schuster Development Corp. v. Dade Sav. & Loan Ass'n, 490 So. 2d 1048 (Fla. 3d DCA 1986); Succession of Montgomery, 506 So. 2d 1309 (La. Ct. App. 2d Cir. 1987), writ denied, 512 So. 2d 1181 (La. 1987).

9 Royal Typewriter Co., a Div. of Litton Business Systems, Inc. v. Xerographic Supplies Corp., 719 F.2d 1092, 37 U.C.C. Rep. Serv. 429 (11th Cir. 1983); Guzell v. Kasztelanka Cafe and Restaurant, Inc., 87 Ill. App. 3d 381, 42 Ill. Dec. 415, 408 N.E.2d 1124 (1st Dist. 1980); Allied Realty, Inc. v. Boyer, 302 N.W.2d 774 (N.D. 1981).

10 Centerre Bank of Branson v. Campbell, 744 S.W.2d 490, 5 U.C.C. Rep. Serv. 2d 1403 (Mo. Ct. App. S.D. 1988); Mahaffey v. Investor's Nat. Sec. Co., 103 Nev. 615, 747 P.2d 890 (1987); Guaranty Federal Sav. Bank v. Horseshoe Operating Co., 793 S.W.2d 652, 11 U.C.C. Rep. Serv. 2d 571 (Tex. 1990).

11 Rohrbacher v. Kleebauer, 119 Cal. 260, 51 P. 341 (1897).

12 Armstrong v. Armstrong, 714 F. Supp. 451, 10 U.C.C. Rep. Serv. 2d 1277 (D. Colo. 1989).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

1. Want, Failure, or Illegality of Consideration

§ 505. Failure of consideration as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 97(1), 370, 452(3)

A.L.R. Library

Repossession by secured seller as affecting his right to recover on note or other obligation given as a downpayment, 49 A.L.R.3d 364

Forms

Forms relating to failure of consideration, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Forms relating to failure of consideration, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

A party may defend against having to pay under a promissory note by arguing failure of consideration for the note.[1] Failure of consideration is the neglect, refusal, or failure of one of the parties to perform or furnish the consideration agreed upon.[2] The defense of "failure of consideration" in an action on a promissory note implies that consideration, once existing and sufficient, has become worthless or ceased to exist,[3] which distinguishes it from "lack" of consideration.[4]

Except as against a holder in due course,[5] if a negotiable instrument is issued for a promise of performance, the issuer has a

defense to the extent performance of the promise is due and the promise has not been performed.[6]

There can be no contention that the consideration for an instrument has failed where the maker has received the full agreed-upon consideration.[7] Thus, withdrawal by a golf club of a maker's right to use the club facilities before the first installment payment was due on the maker's promissory note did not result in a failure of consideration for the promissory note, in an action by the club to collect the balance due on the note, where the note was given to pay for the remainder of the maker's the initiation fee for the club membership, according to his application for membership and the club rules and regulations initiation fee was nonrefundable, the maker did become a member and was granted access to use club facilities, and the payment of the initiation fee did not guarantee the maker continuation of his membership if he breached club rules.[8]

It is well-established, even when a cashier's check is characterized as a bill of exchange, that a bank may assert failure of consideration as a defense to a demand that it pay the cashier's check if enforcement is sought by one who is not a holder in due course.[9]

A defense of total failure of consideration will not stand if the maker received any benefit in exchange for the note.[10]

Footnotes

1 Santomieri v. Mangen, 2018-Ohio-1443, 111 N.E.3d 483 (Ohio Ct. App. 3d Dist. Auglaize County 2018), appeal not allowed, 153 Ohio St. 3d 1462, 2018-Ohio-3258, 104 N.E.3d 792 (2018).

2 Holm v. Woodworth, 271 So. 2d 167, 11 U.C.C. Rep. Serv. 818 (Fla. 4th DCA 1972).

3 Mobley v. Baker, 72 S.W.3d 251 (Mo. Ct. App. W.D. 2002); Bassett v. American Nat. Bank, 145 S.W.3d 692 (Tex. App. Fort Worth 2004).

4 Mobley v. Baker, 72 S.W.3d 251 (Mo. Ct. App. W.D. 2002).

5 § 504.

6 U.C.C. § 3-303(b) [2002].

7 Oakland Medical Bldg. Corp. v. Aureguy, 41 Cal. 2d 521, 261 P.2d 249 (1953).

8 Bonem v. Golf Club of Georgia, Inc., 264 Ga. App. 573, 591 S.E.2d 462, 52 U.C.C. Rep. Serv. 2d 280 (2003).

9 Banco Ganadero Y Agricola, S.A., Agua Prieta, Sonora, Mexico v. Society Nat. Bank of Cleveland, Ohio, 418 F. Supp. 520, 21 U.C.C. Rep. Serv. 233 (N.D. Ohio 1976).

10 Florida Nat. Bank & Trust Co. at Miami v. Smith, 139 So. 2d 438 (Fla. 3d DCA 1962).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

1. Want, Failure, or Illegality of Consideration

§ 506. Want of consideration as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 97(1), 370, 452(3)

Forms

Forms relating to want of consideration, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

The drawer or maker of a negotiable instrument has a defense if the instrument is issued without consideration.[1] The defense of want or absence of consideration, however, may not be asserted as against a holder in due course.[2]

A party otherwise entitled to interpose lack of consideration was not estopped to plead the defense of lack of consideration for the making of an instrument, in an action by an indorsee, by the fact that the party made an interest payment to the indorsee after the transfer of the note had been completed.[3]

The fact that commercial paper is unconditional does not bar proof of the absence of consideration.[4] The fact that a note recites "for value received" does not bar the introduction of parol evidence to show that, in fact, no value was ever received.[5]

Any consideration which would be sufficient to uphold an ordinary contract is sufficient consideration to validate a promissory note.[6]

Footnotes

1 U.C.C. § 3-303(b) [2002].

2 § 504.
As to effect of holder-in-due course status, generally, see § 495.

3 Imperial Gypsum & Oil Corp. v. Chaplin, 4 Cal. App. 2d 109, 40 P.2d 596 (4th Dist. 1935).
As to estoppel to assert defenses, generally, see § 501.

4 Stone v. Blizzard, 137 Misc. 2d 92, 520 N.Y.S.2d 112 (Sup 1987).

5 Iseman v. Hobbs, 290 S.C. 482, 351 S.E.2d 351, 2 U.C.C. Rep. Serv. 2d 1357 (Ct. App. 1986).

6 Hallowell v. Turner, 94 Idaho 718, 496 P.2d 955, 10 U.C.C. Rep. Serv. 1076 (1972).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

1. Want, Failure, or Illegality of Consideration

§ 507. Assertion of lack of consideration as defense to action on negotiable instrument by accommodation party or other third person

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 97(1), 370, 452(3)

It is not a defense to an accommodation party that no consideration was given for his or her signature or obligation as distinguished from consideration for the obligation of the party he or she accommodates; an accommodation party is liable on a note regardless of the absence of any independent consideration for his or her signature.[1] Moreover, even though an instrument was made and indorsed as an accommodation and without consideration, the absence of consideration is not available as a defense to an accommodation maker or indorser when the instrument is taken for value before it is due.[2]

Want of consideration to himself or herself is a defense to an accommodation party who is sued by the party he or she accommodates.[3]

Footnotes

1 Cissna Park State Bank v. Johnson, 21 Ill. App. 3d 445, 315 N.E.2d 675, 15 U.C.C. Rep. Serv. 667 (4th Dist. 1974); Schaeffer v. United Bank & Trust Co. of Maryland, 32 Md. App. 339, 360 A.2d 461, 20 U.C.C. Rep. Serv. 125 (1976), judgment aff'd, 280 Md. 10, 370 A.2d 1138, 21 U.C.C. Rep. Serv. 586 (1977); Transamerica Commercial Finance Corp. v. Naef, 842 P.2d 539, 21 U.C.C. Rep. Serv. 2d 704 (Wyo. 1992).

2 Franklin Nat. Bank v. Eurez Const. Corp., 60 Misc. 2d 499, 301 N.Y.S.2d 845, 6 U.C.C. Rep. Serv. 634 (Sup 1969).

3 § 432.

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12 Am. Jur. 2d Bills and Notes § 508

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

1. Want, Failure, or Illegality of Consideration

§ 508. Illegality of consideration as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 106

Forms

Forms relating to illegal consideration, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Illegality of consideration is not listed among the "real" defenses to which an instrument is subject in the hands of a holder in due course.[1] It has long been held, however, that even in the case of negotiable paper, where an action is brought by a subsequent holder and it is shown that the consideration for the instrument was illegal, a prima facie case of notice to the holder is made out, and the burden of proving that the holder took without notice before maturity and for value is thrown on the holder.[2] Furthermore, the Uniform Commercial Code provides that a defense to the obligation of a party to pay a negotiable instrument exists, even against a holder in due course, where there is illegality in the transaction which, under other law, nullifies the obligation of the obligor. Under this provision, it is left to local law outside the Uniform Commercial Code to determine whether the instrument is absolutely void, or merely voidable.[3]

Footnotes

1 § 496.

2 Union Collection Co. v. Buckman, 150 Cal. 159, 88 P. 708 (1907).

As to the burden of proof with respect to status as a holder in due course, generally, see § 593.
As to the burden of proving defenses to an action on an instrument, see § 590.

[3] § 515.

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12 Am. Jur. 2d Bills and Notes § 509

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

2. Nonissuance, Conditional Issuance, Issuance for Special Purpose

§ 509. Nonissuance, conditional issuance, issuance for special purpose as defense to action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 115, 132, 365(1), 369

Forms

Forms relating to delivery or non-delivery of note, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Nonissuance of the instrument, conditional issuance, and issuance for a special purpose is a defense under the statutory provision making the right to enforce the obligation of a party to pay a negotiable instrument subject to the defenses stated in Revised Article 3.[1]

The defenses of nonissuance, conditional issuance, or issuance for a special purpose, however, are not available as against a holder in due course.[2]

To establish the defense of delivery for a special purpose, the maker must prove that the enforceability of the instrument was predicated on the occurrence of some act or event, not that the instrument was a sham that was never intended to be enforceable.[3]

Nondelivery or conditional delivery must be pleaded as an affirmative defense.[4]

Footnotes

1 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. §§ 3-105(b), 3-305(a)(2) [2002].

2 U.C.C. § 3-305(b) [2002] providing that the right of a holder in due course to enforce an obligation to pay a negotiable instrument is not subject to the defenses stated in U.C.C. § 3-305(a)(2) [2002].
As to the delivery of instruments, generally, see §§ 155 to 159.

3 Perez-Lizano v. Ayers, 215 Mont. 95, 695 P.2d 467 (1985).

4 Seier v. Peek, 456 So. 2d 1079 (Ala. 1984).
As to the burden of proving defenses to an action on an instrument, generally, see § 590.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

2. Nonissuance, Conditional Issuance, Issuance for Special Purpose

§ 510. Nondelivery or nonissuance of incomplete instrument as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 62.1, 63, 365(1)

Treatises and Practice Aids

As to incomplete instruments, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to delivery or non-delivery of note, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Nonissuance of an incomplete instrument is a defense of the maker or drawer of an instrument, under the statutory provision making the right to enforce the obligation of a party to pay a negotiable instrument subject to the defenses stated in Revised Article 3.[1] This defense, however, is not available as against a holder in due course.[2]

Definition:

An incomplete instrument is a signed writing, whether or not issued by the signer, the contents of which show at the time of signing that it is incomplete but that the signer intended it to be completed by the addition of words or numbers.[3] This definition includes both "instruments," that is, writings meeting all the statutory requirements as well as a writing intended to be an instrument that is signed but lacks some element of an instrument.[4] The test in both cases is whether the contents show that it is incomplete and that the signer intended that additional words or numbers be added.[5] The signer must intend not only to complete the writing, but to complete it as an instrument under Revised Article 3. Although nothing in Revised Article 3 establishes criteria for determining the signer's intent, a mere signature on a blank piece of paper is not an incomplete instrument.[6]

If the incomplete instrument satisfies the statutory requirements of an instrument, it may be enforced according to its terms if it is not completed, or according to its terms as augmented by completion. If an incomplete instrument is not an instrument under the statute setting forth the requirements of an instrument, but, after completion, the statutory requirements are met, the instrument may be enforced according to its terms as augmented by completion.[7] An incomplete instrument that satisfies the requirements of an instrument in spite of containing a space or blank for other terms may be enforced according to its terms even if the space or blank is never completed.[8] Where an instrument omits the name of the payee, it is negotiable and payable to bearer.[9] An instrument is also negotiable even if it omits or leaves a blank or space for any of the following terms:

- the rate of interest
- the date unless the instrument is payable a fixed period after the date
- the date of payment
- the place of payment
- a provision for attorney's fees[10]

Footnotes

1 Official Comment 2 to U.C.C. § 3-305 [2002], referring to U.C.C. §§ 3-105(b), 3-305(a)(2) [2002].

2 U.C.C. § 3-305(b) [2002], providing that the right of a holder in due course to enforce an obligation to pay a negotiable instrument is not subject to the defenses stated in U.C.C. § 3-305(a)(2) [2002].

3 U.C.C. § 3-115(a) [2002].

4 Official Comment 1 to U.C.C. § 3-115 [2002], referring to U.C.C. § 3-104 [2002].

5 Official Comment 1 to U.C.C. § 3-115 [2002].

6 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-115:4 (3d ed.).

7 U.C.C. § 3-115(b) [2002], referring to U.C.C. § 3-104 [2002].

8 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-115:5 (3d ed.), referring to U.C.C. § 3-104.

9 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-115:5 (3d ed.).

10 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-115:5 (3d ed.).

Works.

12 Am. Jur. 2d Bills and Notes § 511

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Bills and Notes

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

3. Incapacity or Incompetency of Party

§ 511. Incapacity or incompetency of party as defense to action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 101, 366, 452(1)

To form a contract, it is necessary that there be a party capable of contracting and a party capable of being contracted with. In other words, to enter into a valid, legal agreement, the parties must have the capacity to do so.[1] However, negotiation is effective even if obtained from an infant, a corporation exceeding its powers, or a person without capacity.[2]

A holder in due course does not take the instrument free from the defense of such incapacity as renders the obligation of the party a nullity.[3]

Footnotes

1 Am. Jur. 2d, Contracts § 27.

2 U.C.C. § 3-202(a)(i) [2002].
As to the effect of incapacity, fraud, illegality, and similar factors, see § 188.

3 U.C.C. § 3-305(b) [2002], referring to U.C.C. § 3-305(a)(1) [2002].

12 Am. Jur. 2d Bills and Notes § 512

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

3. Incapacity or Incompetency of Party

§ 512. Infancy as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 101, 366, 452(1)

Treatises and Practice Aids

As to infancy, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to age or infancy, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Except as otherwise provided, the right to enforce the obligation of any party to pay an instrument is subject to a defense of the obligor based on the infancy of the obligor to the extent it is a defense to a simple contract.[1] Nothing in the Uniform Commercial Code specifies when an infant has a defense to its contractual obligations. Rather, reference must be made to the laws of the jurisdiction whose law governs the issue.[2]

Comment:

This provision allows the assertion of the defense of infancy against a holder in due course, even though the effect of the defense is to render the instrument voidable but not void. The policy is one of protection of the infant even at the expense of occasional loss to an innocent purchaser. No attempt is made to state when infancy is available as a defense or the conditions under which it may be asserted. In some jurisdictions, it is held that an infant cannot rescind the transaction or set up the defense unless the holder is restored to the position held before the instrument was taken which, in the case of a holder in due course, is normally impossible. In other states, an infant who has misrepresented his or her age may be estopped to assert infancy. Such questions are left to other law, as an integral part of the policy of each state as to the protection of infants.[3]

Negotiation by a minor is effective to transfer an instrument. However, to the extent permitted by other law, such negotiation may be rescinded or may be subject to other remedies, but those remedies may not be asserted against a subsequent holder in due course or a person paying the instrument in good faith and without knowledge of the facts that are the basis for rescission or other remedy.[4]

Footnotes

1 U.C.C. § 3-305(a)(1)(i) [2002].

2 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:6 (3d ed.).

3 Official Comment 1 to U.C.C. § 3-305 [2002].

4 § 188.

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12 Am. Jur. 2d Bills and Notes § 513

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

3. Incapacity or Incompetency of Party

§ 513. Lack of legal capacity as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 101, 366, 452(1)

A.L.R. Library

Duress, Incapacity, Illegality, or Similar Defense Rendering Obligation a Nullity as Affecting Enforceability of Negotiable Instrument Against Holder in Due Course Under U.C.C. [rev] s3-305(a)(1)(ii), 89 A.L.R.5th 577

Insanity of maker, drawer, or indorser as defense against holder in due course, 24 A.L.R.2d 1380

Treatises and Practice Aids

As to void obligation—lack of legal capacity, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to incompetency or legal capacity, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

The right to enforce the obligation of a party to pay a negotiable instrument is subject to a defense of the obligor based on lack of legal capacity which, under other law, nullifies the obligation of the obligor.[1] The incapacity to contract of a person, whether under statutory or case law, may be raised as a defense against any person including a person having the rights of a holder in due course.[2] Thus, a husband who lacked the capacity to purchase community real property without his wife's consent or subsequent ratification could assert such incapacity in an action by a bank against the husband and wife on a note executed by the husband for the property's purchase price as a defense to liability of the defendants' community property for such note; the bank was thus a holder in due course only of the husband's separate obligation.[3]

This section covers mental incompetence, guardianship, ultra vires acts or lack of corporate capacity to do business, or any other incapacity apart from infancy. Such incapacity is largely statutory. Its existence and effect is left to the law of each state. If under the state law the effect is to render the obligation of the instrument entirely null and void, the defense may be asserted against a holder in due course. If the effect is merely to render the obligation voidable at the election of the obligor, the defense is cut off.[4]

Observation:

Negotiation is effective to transfer an instrument even if obtained from a person without capacity. However, to the extent permitted by other law, such negotiation may be rescinded or may be subject to other remedies, but those remedies may not be asserted against a subsequent holder in due course or a person paying the instrument in good faith and without knowledge of the facts that are the basis for rescission or other remedy.[5]

Footnotes

1 U.C.C. § 3-305(a)(1)(ii) [2002].

2 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:9 (3d ed.).

3 Colorado Nat. Bank of Denver v. Merlino, 35 Wash. App. 610, 668 P.2d 1304 (Div. 1 1983).

4 Official Comment 1 to U.C.C. § 3-305 [2002].
As to the capacity to contract, generally, see Am. Jur. 2d, Contracts § 27.

5 § 188.

12 Am. Jur. 2d Bills and Notes § 514

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

3. Incapacity or Incompetency of Party

§ 514. Lack of corporate capacity as defense to action on negotiable instrument; ultra vires acts

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 101, 366, 367, 452(1)

A.L.R. Library

Construction and effect of constitutional or statutory provisions precluding issuance of corporate stock in consideration of promissory notes, 78 A.L.R.2d 834

The provision under which incapacity renders the obligation of the party a nullity is a defense, even as against a holder in due course,[1] covers ultra vires acts or lack of corporate capacity to do business.[2]

Observation:

Negotiation is effective to transfer an instrument, even if obtained from a corporation exceeding its powers. However, to the extent permitted by other law, such negotiation may be rescinded or may be subject to other remedies, but those remedies may not be asserted against a subsequent holder in due course or a person paying the instrument in good faith and without knowledge of the facts that are the basis for rescission or other remedy.[3]

Footnotes

1 § 513.

2 Official Comment 1 to U.C.C. § 3-305 [2002].
As to the doctrine of ultra vires, generally, see Am. Jur. 2d, Corporations §§ 1712 to 1731.

3 § 188.

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12 Am. Jur. 2d Bills and Notes § 515

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

4. Illegality or Public Policy

§ 515. Illegality or violation of public policy as defense to action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 106, 108.1, 375, 452(1)

A.L.R. Library

Duress, Incapacity, Illegality, or Similar Defense Rendering Obligation a Nullity as Affecting Enforceability of Negotiable Instrument Against Holder in Due Course Under U.C.C. [rev] s3-305(a)(1)(ii), 89 A.L.R.5th 577

Treatises and Practice Aids

As to void obligation—illegality, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to illegality, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Except as otherwise provided, the right to enforce the obligation of a party to pay an instrument is subject to a defense of the obligor based on illegality of the transaction which, under other law, nullifies the obligation of the obligor.[1] The right of a holder in due course to enforce the obligation of a party to pay the instrument is subject to this defense of the obligor.[2] The illegality of a negotiable instrument defeats a claim of a holder in due course only when an obligation under the instrument is made entirely null and void under local law, and if an obligation under a negotiable instrument is merely voidable at the election of the payor, the defense of illegality is unavailable against a holder in due course.[3] As against a person not a holder in due course illegality that merely makes the obligation voidable may be assertible as a defense.[4]

Comment:

Illegality is most frequently a matter of gambling or usury, but may arise in other forms under a variety of statutes. The statutes differ in their provisions and the interpretations given them. They are primarily a matter of local concern and local policy. All such matters are, therefore, left to the local law. If under the local law the effect of the illegality is to make the obligation entirely null and void, the defense may be asserted against a holder in due course. Otherwise, it is cut off.[5]

The following uses of an instrument are examples of what may be sufficient illegality under state law to constitute a defense against a holder in due course:

• payment of a gambling debt

• payment of a bribe

• use of the instrument to purchase known stolen property
• extraction of a usurious rate of interest[6]
Similarly, a promissory note by which the maker paid money to the holder to secure influence over a criminal proceeding is void as against public policy.[7]

The fact that the illegality is an act which is also a crime does not compel the conclusion that the contract based thereon is void, as distinguished from voidable.[8] Similarly, fraud which induces the making of a contract does not cause the contract to be a nullity, even though the fraud may be such as to constitute a crime.[9]

A contract induced by commercial bribery is voidable but not void.[10] However, when a note is given in payment of the purchase price for the sale of a patent and the patent is void, the note is also void.[11]

Where the law in question, such as federal banking regulations, does not purport to affect the rights of the parties inter se, and provides no private remedy, the illegality of the transaction is not a defense.[12]

A mere conclusory averment of illegality is not sufficient to bar recovery by a payee bank when no facts are pleaded to connect the payee to any illegality or to show any knowledge on its part that the loan it was making to the maker was in furtherance of a criminal plan.[13]

Observation:

Negotiation is effective to transfer an instrument, even if obtained as part of an illegal transaction. However, to the extent permitted by other law, such negotiation may be rescinded or may be subject to other remedies, but those remedies may not be asserted against a subsequent holder in due course or a person paying the instrument in good faith and without knowledge of the

facts that are the basis for rescission or other remedy.[14]

Footnotes

1 U.C.C. § 3-305(a)(1)(ii) [2002].

2 U.C.C. § 3-305(b) [2002].

3 RR Maloan Investments, Inc. v. New HGE, Inc., 428 S.W.3d 355, 83 U.C.C. Rep. Serv. 2d 311 (Tex. App. Houston 14th Dist. 2014).

4 U.C.C. § 3-305(a)(2) [2002], subjecting an instrument not in the hands of a holder in due course to any defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract.

5 Official Comment 1 to U.C.C. § 3-305 [2002].
As to consideration for gambling or wagering transactions, see § 516.
As to usurious transactions, generally, see § 517.

6 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:10 (3d ed.).

7 Rademacher v. Becker, 2015 COA 133, 374 P.3d 499 (Colo. App. 2015).

8 Bankers Trust Co. v. Litton Systems, Inc., 599 F.2d 488, 26 U.C.C. Rep. Serv. 513 (2d Cir. 1979).

9 Citizens Nat. Bank of Quitman v. Brazil, 141 Ga. App. 388, 233 S.E.2d 482, 21 U.C.C. Rep. Serv. 810 (1977).

10 Bankers Trust Co. v. Litton Systems, Inc., 599 F.2d 488, 26 U.C.C. Rep. Serv. 513 (2d Cir. 1979).

11 Frequency Electronics, Inc. v. National Radio Co., Inc., 422 F. Supp. 609, 20 U.C.C. Rep. Serv. 680 (S.D. N.Y. 1975), judgment aff'd, 546 F.2d 497, 20 U.C.C. Rep. Serv. 684 (2d Cir. 1976).

12 Hinnant v. American Nat. Bank and Trust Co. of Ft. Lauderdale, 406 So. 2d 1206 (Fla. 4th DCA 1981).

13 Bank of Baroda v. Shah, 191 A.D.2d 237, 594 N.Y.S.2d 255 (1st Dep't 1993).

14 § 188.

12 Am. Jur. 2d Bills and Notes § 516

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

4. Illegality or Public Policy

§ 516. Illegality of gambling or wagering transactions as providing defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 106, 375

Forms

Forms relating to illegality, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Illegality frequently arises under gaming statutes, and because such statutes are primarily a matter of local concern and local policy, matters involving the same are left to the local law. If under the local law the effect of illegality is to make the obligation entirely null and void, the defense may be asserted against a holder in due course. Otherwise, it is cut off.[1]

A London gambling club which was the holder of nine bearer checks, drawn by the defendant, who maintained a business office in Connecticut, in connection with gambling transactions in London, could not recover on such checks because (1) the defendant drawer, under Connecticut law, was entitled to raise a statutory defense of illegal consideration against liability on the checks; and (2) even if the plaintiff were a holder in due course as to the checks, it would still be subject to the defendant's liability defenses because it had dealt directly with the defendant in gambling transactions with respect to which the checks were given.[2] Similarly, checks drawn for the purpose of gambling are void and unenforceable in Nevada.[3]

The burden of proving a gambling purpose is on the party seeking to avoid liability, but there is a presumption of a gambling purpose where the transaction occurs in proximity to the gambling itself in terms of both time and space.[4]

Where a defendant, who had executed credit applications to two casinos and over a period of years had patronized the

casinos, borrowed against these lines of credit on gambling junkets, and previously repaid sums so borrowed, the defendant's history of gambling and the fact that the present unpaid advances were made to him in the form of chips in proximity to the gambling activities were facts which, under the law of Nevada, supported the presumption that the loans were made for a gambling purpose. Thus, such debts and the checks evidencing them were void and unenforceable.[5]

Observation:

Negotiation is effective to transfer an instrument, even if obtained as part of an illegal transaction. However, to the extent permitted by other law, such negotiation may be rescinded or may be subject to other remedies, but those remedies may not be asserted against a subsequent holder in due course or a person paying the instrument in good faith and without knowledge of the facts that are the basis for rescission or other remedy.[6]

Footnotes

1 Official Comment 1 to U.C.C. § 3-305 [2002].

2 Casanova Club v. Bisharat, 189 Conn. 591, 458 A.2d 1, 35 U.C.C. Rep. Serv. 1207 (1983).

3 Sandler v. Eighth Judicial Dist. Court In and For Clark County, 96 Nev. 622, 614 P.2d 10, 29 U.C.C. Rep. Serv. 1546 (1980); Sea Air Support, Inc. v. Herrmann, 96 Nev. 574, 613 P.2d 413, 29 U.C.C. Rep. Serv. 918 (1980).

4 National Recovery Systems v. Ornstein, 541 F. Supp. 1131, 33 U.C.C. Rep. Serv. 1697 (E.D. Pa. 1982).

5 National Recovery Systems v. Ornstein, 541 F. Supp. 1131, 33 U.C.C. Rep. Serv. 1697 (E.D. Pa. 1982).

6 § 188.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

4. Illegality or Public Policy

§ 517. Usurious transactions as providing defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 106, 108.1, 376

A.L.R. Library

Leaving part of loan on deposit with lender as usury, 92 A.L.R.3d 769

Contingency as to borrower's receipt of money or other property from which loan is to be repaid as rendering loan usurious, 92 A.L.R.3d 623

Statute denying defense of usury to corporation, 63 A.L.R.2d 924

Usury: expenses or charges in form of commissions to agents, brokers, or like intermediaries incident to loan of money, 52 A.L.R.2d 703

Illegality of a transaction as renders the obligation of a party a nullity, thus constituting a defense good even against a holder in due course,[1] may arise because of usury statutes. Such statutes are a matter of local policy and are left to local law; therefore, if under local law the effect of such illegality is to make the obligation entirely null and void, the defense may be asserted against a holder in due course. Otherwise, it is cut off.[2] However, when the usury statute merely forfeits interest or principal as the penalty for usury, but does not make the obligation void, the defense of usury may not be raised against a holder in due course.[3] Holders of a promissory note who are not holders in due course do not take their interest free the defense of usury.[4]

The general rule is that, regardless of whether the statute declares the contract void as a whole, or only to the extent of the usury, the right to defend against or attack a contract or security on the ground that it is tainted with usury is a right personal to the borrower or debtor. Usury remedies are personal to the debtor and restricted to the parties to the transaction. They are

not available to a stranger to the loan transaction.[5]

A defense of civil usury is not available to a corporation.[6]

If usury in the transfer of an instrument exists, it is not a defense to the maker or other party prior to the usury.[7]

When a note is usurious, the usury infects any renewal note.[8]

Footnotes

1 § 515.

2 Official Comment 1 to U.C.C. § 3-305 [2002].

3 AgriStor Credit Corp. v. Lewellen, 472 F. Supp. 46, 26 U.C.C. Rep. Serv. 1014 (N.D. Miss. 1979); Cromwell v. All State Credit Corp., 10 U.C.C. Rep. Serv. 403 (D.C. Super. Ct. 1971).

4 Creative Ventures, LLC v. Jim Ward & Associates, 195 Cal. App. 4th 1430, 126 Cal. Rptr. 3d 564, 74 U.C.C. Rep. Serv. 2d 641 (6th Dist. 2011).

5 Am. Jur. 2d, Interest and Usury § 211.

6 Ludlum Corp. Pension Plan Trust v. Matty's Superservice, Inc., 156 A.D.2d 339, 548 N.Y.S.2d 292 (2d Dep't 1989).

7 Sedbury v. Duffy, 158 N.C. 432, 74 S.E. 355 (1912).

8 Williams v. Powell, 214 Ga. App. 216, 447 S.E.2d 45 (1994).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

4. Illegality or Public Policy

§ 518. Miscellaneous illegalities as providing defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 106, 108.1, 375

A.L.R. Library

Construction and effect of statute as to doing business under an assumed or fictitious name or designation not showing the names of the persons interested, 42 A.L.R.2d 516

The following illegalities have been held not to constitute a defense against a holder in due course:

- that securities were sold in violation of the Blue Sky Laws[1]
- that a payee/seller was doing business under, and took a note in, a tradename which it had not registered as required by statute[2]
- that an instrument was given in contravention of the bankruptcy statute[3] as where it was exacted as a preference for uniting in a deed of composition[4]
- that a note was executed under unethical circumstances to improve the financial condition of the bank before it was examined[5]

Footnotes

[1] Bank of Balboa v. Benneson, 122 Cal. App. 121, 9 P.2d 540 (1st Dist. 1932); Molsons Bank v. Berman, 224 Mich. 606, 195 N.W. 75, 35 A.L.R. 1289 (1923); National Bank of the Republic v. Price, 65 Utah 57, 234 P. 231 (1923).

[2] Peoples Loan & Finance Corp. v. Latimer, 183 Ga. 809, 189 S.E. 899 (1937).

[3] Cowing v. Altman, 71 N.Y. 435, 1877 WL 10353 (1877).

[4] New Howard Mfg. Co. v. Cohen, 207 A.D. 588, 202 N.Y.S. 449 (1st Dep't 1924).

[5] Scott v. Citizens Bank of Americus, 188 Ga. App. 618, 373 S.E.2d 633, 8 U.C.C. Rep. Serv. 2d 68 (1988).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

5. Fraud

§ 519. Fraud as defense to action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 103(1), 103(2), 373, 380, 381, 452(4)

Forms

Forms relating to fraud, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

It is settled that fraud committed at the time an instrument has its origin or inception is a defense against a holder not protected as a holder in due course,[1] and that, as between the original parties to a negotiable instrument, or as against holders other than holders in due course, fraud may be set up as a defense against liability on the instrument.[2]

Observation:

Generally speaking only the original purchaser of a note has standing to sue for fraud, because only it could have relied upon the fraudulent statements.[3]

The necessary elements of fraud must exist in order to constitute fraud as a defense[4] or grounds for relief.[5] The Uniform

Commercial Code does not contain any definition of fraud as it relates to a defense against a party, but the express preservation of contract law and of the law of fraud will have the effect in most jurisdictions of requiring that the commercial paper defendant establish the elements of "fraud" that would be required in an ordinary contract action.[6] A general rule cannot be readily established for the effect of fraudulent practices and each case must be considered carefully on the basis of its own facts.[7]

A mere conclusory statement of fraud is not sufficient as a defense to a promissory note.[8]

Oral statements as to the making of future payments cannot rise to fraud, so as to be a defense to liability for the face of the paper.[9] There is no liability for failure to disclose in the absence of a duty to make a disclosure.[10] Misrepresentations made after a note has been executed do not give rise to a defense against enforcement of the note.[11]

Because the defense of fraud may be waived, the party defrauded must be careful to stay at arm's length from the other party. The party defrauded must comply with the terms of the contract on that party's part, must not ask favors of the other party or offer to perform the contract on conditions the defrauded party has no right to exact, and must not make any new agreement or engagement respecting the contract.[12]

The maker of a note is barred from asserting fraud in the underlying transaction when the circumstances are such as to amount to a ratification of the transaction.[13]

Observation:

Negotiation is effective to transfer an instrument, even if obtained by fraud. However, to the extent permitted by other law, such negotiation may be rescinded or may be subject to other remedies, but those remedies may not be asserted against a subsequent holder in due course or a person paying the instrument in good faith and without knowledge of the facts that are the basis for rescission or other remedy.[14]

Footnotes

1 New York Bankers v. Duncan, 257 N.Y. 160, 177 N.E. 407 (1931); Westbury Small Business Corp. v. Ballarine, 125 A.D.2d 462, 509 N.Y.S.2d 569 (2d Dep't 1986).

2 Gerlach v. Donnelly, 98 So. 2d 493 (Fla. 1957).

3 Pennsylvania Public School Employees' Retirement System v. Morgan Stanley & Co., Inc., 772 F.3d 111, 89 Fed. R. Serv. 3d 1787 (2d Cir. 2014), as amended, (Nov. 12, 2014) and certified question accepted, 24 N.Y.3d 1028, 997 N.Y.S.2d 679, 22 N.E.3d 187 (2014) and certified question answered on other grounds, 25 N.Y.3d 543, 14 N.Y.S.3d 313, 35 N.E.3d 481 (2015) (under New York law).

4 Edison Stone Corp. v. 42nd Street Development Corp., 145 A.D.2d 249, 538 N.Y.S.2d 249 (1st Dep't 1989).
As to the essential elements of an action for fraud, see Am. Jur. 2d, Fraud and Deceit §§ 22 to 30.

5 First Nat. Bank v. Level Club, 254 A.D. 255, 4 N.Y.S.2d 734 (1st Dep't 1938), judgment aff'd, 282 N.Y. 577, 24 N.E.2d 991 (1939).

6 Chemical Bank of Rochester v. Ashenburg, 94 Misc. 2d 64, 405 N.Y.S.2d 175 (Sup 1978).

7 Burchett v. Allied Concord Financial Corp., 1964-NMSC-231, 74 N.M. 575, 396 P.2d 186, 2 U.C.C. Rep. Serv. 279

(1964).

8 J & B Schoenfeld Fur Merchants, Inc. v. Kilbourne & Donohue, Inc., 704 F. Supp. 466, 9 U.C.C. Rep. Serv. 2d 968 (S.D. N.Y. 1989); Chrysler Credit Corp. v. Dioguardi Jeep Eagle, Inc., 192 A.D.2d 1066, 596 N.Y.S.2d 230 (4th Dep't 1993).

9 Marchman Oil and Chemical Co., Inc. v. Southern Petroleum Trading Co., Ltd., 167 Ga. App. 691, 307 S.E.2d 509 (1983).

10 Custom Craft Tile, Inc. v. Bridgecrest, Inc., 662 S.W.2d 320, 37 U.C.C. Rep. Serv. 1204 (Mo. Ct. App. E.D. 1983).

11 Bale v. Mammoth Cave Production Credit Ass'n, 652 S.W.2d 851 (Ky. 1983).

12 Howland v. Scott, 117 Cal. App. 275, 4 P.2d 200 (3d Dist. 1931).
As to the waiver of defenses, see § 502.

13 Yawn v. Powell, 146 Ga. App. 554, 246 S.E.2d 737 (1978).

14 § 188.

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12 Am. Jur. 2d Bills and Notes § 520

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Bills and Notes

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

5. Fraud

§ 520. Fraud in inducement as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 103(1), 373, 452(4)

A.L.R. Library

Fraud in the inducement and fraud in the factum as defenses under U.C.C. sec. 3-305 against holder in due course, 78 A.L.R.3d 1020

Forms

Forms relating to fraud, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Forms relating to fraud, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Fraud in the inducement is a good defense to the enforceability of an obligation to pay a promissory note.[1] The Uniform Commercial Code restates the prior law with respect to the effect of fraud as to the inducement.[2] In determining whether fraud as to the inducement exists, the courts follow the pre-Code definition of fraud,[3] which approach to the problem is, of course, mandated by the Code provision, which declares that the law as to fraud continues under the Code, unless displaced.[4]

Fraud in the inducement exists where a party fully understands what he or she is signing, and is aware of the nature and

character of the instrument executed, but is deceived by fraudulent representations as to the facts outside the instrument itself.[5] Fraud in the inducement is available to the obligor as a defense against one other than a holder in due course, since it is a defense that would be available under a simple contract.[6] Fraud in the inducement cannot be raised against a holder in due course.[7]

In order to constitute the defense of fraudulent inducement of a contract, the representation in question (1) must be of a material fact which has been made for the purpose of inducing the other party to act; (2) must be known to be false by the maker, but reasonably believed to be true by the other party; and (3) must be relied upon by such party and acted upon to his or her damage.[8] For example, when the obligor fraudulently misrepresents his or her intention to perform the contract, there is fraud in the inducement.[9] Similarly, when the holder induces the signing of the renewal note on the representation that the note was secured when, in fact, it was not, because the collateral for the note had already been sold, there is fraud as to inducement when the holder, in fact, knew that the collateral had already been sold.[10] Lack of reasonable or justifiable reliance on alleged misrepresentations negates the defense.[11]

The defense of fraud in the inducement was available against the payee, even though the fraud consisted of the false making of a promise, which promise would not be binding, because there was no writing to satisfy the Statute of Frauds.[12]

The mere representation by the payee to the maker, that the maker would not be liable on the note, does not constitute fraud in the inducement; to constitute fraud in the inducement, in addition to the payee's representation that the maker would not be liable, there must be a showing of some type of trickery, artifice, or device that was employed by the payee.[13] The fact that promises are not kept does not constitute fraud as to the inducement.[14] The failure to perform a promise as to the future does not constitute fraud when the promise was not made with the intent to deceive.[15] The fact that the execution of a note was induced by sales talk does not constitute a defense to liability on the note, as such statements do not constitute fraud.[16]

Fraud in the inducement renders a note voidable but not void.[17]

Footnotes

1 Roca Properties, LLC v. Dance Hotlanta, Inc., 327 Ga. App. 700, 761 S.E.2d 105 (2014).
A defendant may pursue a fraudulent inducement claim premised on an oral misrepresentation to forego demanding repayment of a note. McCabe v. Green, 39 Misc. 3d 270, 961 N.Y.S.2d 841 (Sup 2013).

2 Marine Midland Trust Co. of Rochester v. Blackburn, 50 Misc. 2d 954, 271 N.Y.S.2d 388, 3 U.C.C. Rep. Serv. 740 (Sup 1966).

3 Vandeputte v. Soderholm, 298 Minn. 505, 216 N.W.2d 144 (1974); Foyer Key Sung v. Ramirez, 121 Misc. 2d 313, 467 N.Y.S.2d 486 (Sup 1983); First State Bank of Miami v. Fatheree, 847 S.W.2d 391 (Tex. App. Amarillo 1993), writ denied, (Sept. 10, 1993).

4 U.C.C. § 1-103(b)[2001].

5 Belleville Nat. Bank v. Rose, 119 Ill. App. 3d 56, 74 Ill. Dec. 779, 456 N.E.2d 281 (5th Dist. 1983).

6 U.C.C. § 3-305(a)(2) [2002], subjecting an instrument not in the hands of a holder in due course to any defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract.
As to fraud in inducement as affecting formation of contract, generally, see Am. Jur. 2d, Contracts § 209.

7 Mellon Bank, N.A. v. Ternisky, 999 F.2d 791, 26 Fed. R. Serv. 3d 546 (4th Cir. 1993); Federal Deposit Ins. Corp. v. Aetna Cas. & Sur. Co., 947 F.2d 196, 15 U.C.C. Rep. Serv. 2d 941 (6th Cir. 1991); Stotler v. Geibank Indus. Bank, 827 P.2d 608 (Colo. App. 1992); Lassiter v. Resolution Trust Corp., 610 So. 2d 531 (Fla. 5th DCA 1992); Schuster v. CIC-Union Europeene Intern., 208 Ga. App. 646, 431 S.E.2d 378 (1993); Countrywide Home Loans Servicing, L.L.P. v. Heck, 2011-Ohio-147, 2011 WL 281148 (Ohio Ct. App. 6th Dist. Ottawa County 2011).

8 FPI Development, Inc. v. Nakashima, 231 Cal. App. 3d 367, 282 Cal. Rptr. 508 (3d Dist. 1991); Schwaner v.

Belvidere Medical Bldg. Partnership, 155 Ill. App. 3d 976, 108 Ill. Dec. 361, 508 N.E.2d 522, 4 U.C.C. Rep. Serv. 2d 785 (2d Dist. 1987).
The maker of a promissory note has standing to assert a tort claim of fraud in the inducement as a defense and/or a counterclaim in response to the lender's attempt to recover a debt on the promissory note where the maker can demonstrate reliance to his or her financial detriment upon the oral promise of the lender, which the lender had no contemporaneous intention of fulfilling, and notwithstanding the fact that a third party was the beneficiary of the oral promise. Traders Bank v. Dils, 226 W. Va. 691, 704 S.E.2d 691 (2010).

[9] Sanitary and Improvement Dist. No. 32 of Sarpy County v. Continental Western Corp., 215 Neb. 843, 343 N.W.2d 314, 38 U.C.C. Rep. Serv. 516 (1983).

[10] Lee v. Heights Bank, 112 Ill. App. 3d 987, 68 Ill. Dec. 514, 446 N.E.2d 248 (3d Dist. 1983).

[11] JPMorgan Chase Bank, N.A. v. Asia Pulp & Paper Co., Ltd., 707 F.3d 853, 84 Fed. R. Serv. 3d 1416, 79 U.C.C. Rep. Serv. 2d 699 (7th Cir. 2013); Citibank, N.A. v. Fiorilla, 121 A.D.3d 435, 994 N.Y.S.2d 566 (1st Dep't 2014).

[12] Crystal Springs Ins. Agency, Inc. v. Commercial Union Ins. Co., 554 So. 2d 884 (Miss. 1989).

[13] Wooldridge v. Groos Nat. Bank, 603 S.W.2d 335, 29 U.C.C. Rep. Serv. 1548 (Tex. Civ. App. Waco 1980).

[14] McGarr v. Bank of Pinehurst, 159 Ga. App. 116, 282 S.E.2d 739 (1981); Bank of Hawaii v. Allen, 2 Haw. App. 185, 628 P.2d 211, 31 U.C.C. Rep. Serv. 1645 (1981); Lindeburg v. Gulfway Nat. Bank, 624 S.W.2d 278 (Tex. App. Corpus Christi 1981), writ refused n.r.e., (Feb. 3, 1982).

[15] Benderson Development Co., Inc. v. Hallaway Properties, Inc., 115 A.D.2d 339, 495 N.Y.S.2d 820 (4th Dep't 1985), order aff'd, 67 N.Y.2d 963, 502 N.Y.S.2d 1001, 494 N.E.2d 106 (1986).

[16] Charter Medical Management Co. v. Ware Manor, Inc., 159 Ga. App. 378, 283 S.E.2d 330 (1981).

[17] Langley v. Federal Deposit Ins. Corp., 484 U.S. 86, 108 S. Ct. 396, 98 L. Ed. 2d 340, 5 U.C.C. Rep. Serv. 2d 1 (1987).

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12 Am. Jur. 2d Bills and Notes § 521

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

5. Fraud

§ 521. Fraud in the factum as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 103(1), 373, 452(4)

A.L.R. Library

Fraud in the inducement and fraud in the factum as defenses under U.C.C. sec. 3-305 against holder in due course, 78 A.L.R.3d 1020

Forms

Forms relating to fraud, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Forms relating to fraud, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Fraud in the factum, also known as real or essential fraud, is a defense to the enforcement of an obligation to pay a negotiable instrument.[1] Fraud in the factum exists where a person is induced to sign something entirely different from what that person thought he or she was signing.[2]

Except as otherwise provided, the right to enforce the obligation of a party to pay an instrument is subject to a defense of the obligor based on fraud that induced the obligor to sign the instrument with neither knowledge nor a reasonable opportunity to

learn of its character or its essential terms.[3] Thus, with respect to the defense of fraud in the factum, all plaintiffs stand alike; the defense is a universal defense and the status of holder in due course does not confer any protection.[4] Fraud in the essence or fraud in the factum, in the absence of negligence, is a real defense available against holders in due course.[5]

Comment:

The common illustration is that of the maker who is tricked into signing a note in the belief that it is merely a receipt or some other document, although the defense also extends to an instrument signed with knowledge that it is a negotiable instrument, but without knowledge of its essential terms.[6]

Footnotes

1 In re Balko, 348 B.R. 684 (Bankr. W.D. Pa. 2006).

2 Savoy v. White, 788 F. Supp. 69 (D. Mass. 1992); Norstar Bank of Upstate N.Y. v. Office Control Systems, Inc., 165 A.D.2d 265, 566 N.Y.S.2d 743 (3d Dep't 1991).
A debtor could not demonstrate that a loan document was void because of fraud in the factum as there was no dispute that the debtor had the opportunity to read the language of the loan document before signing it. Taunton Federal Credit Union v. Weiner, 76 Mass. App. Ct. 1128, 925 N.E.2d 574 (2010).
As to fraud in factum as affecting formation of contract, generally, see Am. Jur. 2d, Contracts § 210.

3 U.C.C. § 3-305(a)(1)(iii) [2002].
As to the law regarding fraud, generally, see Am. Jur. 2d, Fraud and Deceit §§ 1 to 498.

4 Stotler v. Geibank Indus. Bank, 827 P.2d 608 (Colo. App. 1992); DeVerna v. Kinney Systems, Inc., 146 Misc. 2d 276, 556 N.Y.S.2d 190 (App. Term 1990); Scott v. Commercial Services of Perry, Inc., 121 S.W.3d 26 (Tex. App. Tyler 2003).
Fraud in the execution is a viable defense to collection efforts by a holder in due course. Laborers' Pension Fund v. A & C Environmental, Inc., 301 F.3d 768, 53 Fed. R. Serv. 3d 990 (7th Cir. 2002).

5 Federal Deposit Ins. Corp. v. Aetna Cas. & Sur. Co., 947 F.2d 196, 15 U.C.C. Rep. Serv. 2d 941 (6th Cir. 1991); Ohio Sav. Bank v. Progressive Cas. Ins. Co., 521 F.3d 960 (8th Cir. 2008); Massey-Ferguson Credit Corp. v. Wiley, 655 F. Supp. 655, 3 U.C.C. Rep. Serv. 2d 1153 (M.D. Ga. 1987).
In order to preclude liability on a negotiable instrument from a holder in due course, it must be apparent on the face of the instrument that it is fraudulent. Triffin v. Somerset Valley Bank, 343 N.J. Super. 73, 777 A.2d 993, 44 U.C.C. Rep. Serv. 2d 1200 (App. Div. 2001).

6 Official Comment 1 to U.C.C. § 3-305 [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

5. Fraud

§ 522. Fraud in the factum as defense to action on negotiable instrument—Effect of negligence or inexcusable ignorance as to character or terms of instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 103(1), 373, 452(4)

Treatises and Practice Aids

As to fraud in the factum, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

There are two requirements that an obligor must prove in order to successfully assert the defense of fraud in the factum.[1] First, the obligor must have signed the instrument without knowledge of its character or essential terms. Ignorance of the character of the instrument requires more than simply not knowing that the instrument is negotiable. The obligor must believe that he or she is signing something other than a promise to pay money.[2] Successful assertion of this defense when based upon not knowing the character of a writing have involved obligors who have believed that they were signing: an application for credit, a receipt, a character reference, or an acknowledgment of wages.[3] The second requirement is that the obligor must not have had a reasonable opportunity to learn of the character or essential terms of the instrument. In other words, the obligor's ignorance of the character or essential terms must have been excusable.[4]

It is a well-settled rule that where one voluntarily signs a negotiable instrument, supposing it to be an obligation of a different character, but has full means of information in the premises and neglects to avail himself or herself thereof, relying on the representations of another, such person cannot set up such ignorance and mistake as a defense against an innocent holder for value before maturity.[5] Thus, one who signs a note without reading it is deemed to be negligent, and fraud would not be a defense to an action on the note by a holder in due course.[6]

In order to establish fraud in the factum as a defense under the Uniform Commercial Code, the defendant must prove that he or she lacked knowledge as to the true character of the paper signed or its essential terms and that he or she did not have a reasonable opportunity to obtain such knowledge.[7]

Comment:

The test of the defense is that of excusable ignorance of the contents of the writing signed. The party must not only have been in ignorance, but must also have had no reasonable opportunity to obtain knowledge. In determining what is a reasonable opportunity, all relevant factors are to be taken into account, including the intelligence, education, business experience, and ability to read and understand English of the signer. Also relevant is the nature of the representations that were made, whether the signer had good reason to rely on the representations or to have confidence in the person making them, the presence or absence of any third person who might read or explain the instrument to the signer, or any other possibility of obtaining independent information, and the apparent necessity, or lack of it, for acting without delay. Unless the misrepresentation meets this test, the defense is cut off by a holder in due course.[8]

Fraud in the factum is not available as a defense where a debtor cannot show that he or she had no reasonable opportunity to obtain knowledge of the instrument's character or its essential terms at the time of signing the contract in blank and never bothered to discover anything about it.[9]

Footnotes

1 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:13 (3d ed.).

2 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:13 (3d ed.).

3 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:13 (3d ed.).

4 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-305:14 (3d ed.).

5 New Bedford Inst. for Sav. v. Gildroy, 36 Mass. App. Ct. 647, 634 N.E.2d 920, 25 U.C.C. Rep. Serv. 2d 450 (1994); Ricks v. Bank of Dixie, 352 So. 2d 798 (Miss. 1977).

6 Leedy v. Ellsworth Const. Co., 9 Ohio App. 2d 1, 38 Ohio Op. 2d 18, 222 N.E.2d 653 (4th Dist. Lawrence County 1966).

7 Leasing Service Corp. v. River City Const., Inc., 743 F.2d 871, 39 U.C.C. Rep. Serv. 1054 (11th Cir. 1984); Federal Deposit Ins. Corp. v. Culver, 640 F. Supp. 725, 1 U.C.C. Rep. Serv. 2d 1585 (D. Kan. 1986); F.D.I.C. v. Rusconi, 808 F. Supp. 30 (D. Me. 1992).

8 Official Comment 1 to U.C.C. § 3-305 [2002].

9 Ford Motor Credit Co. v. Branch, 805 F. Supp. 42, 19 U.C.C. Rep. Serv. 2d 1097 (M.D. Ga. 1992); National Loan Investors, L.P. v. Martin, 488 N.W.2d 163, 19 U.C.C. Rep. Serv. 2d 193 (Iowa 1992).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

5. Fraud

§ 523. Fraud in the factum or fraud in the inducement as defense available to comaker, indorser, or surety

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 103(1), 373, 452(4)

An indorser or surety may defend on the ground of fraud inducing the contract of the principal where the principal makes the same defense,[1] but fraud in the inducement is a defense personal to the principal, which may not be set up by a surety on an instrument, unless the principal repudiates the contract on that ground.[2] At any rate, the indorsement of a renewal note with knowledge of the fraud is an affirmance of the contract.[3]

Where no representation is made to a comaker of a note that the instrument was anything other than a note, the comaker may not successfully assert misrepresentation that constitutes fraud in the factum as a defense to liability.[4]

Footnotes

1 Pioneer Credit Corp. v. Bon Bon Cleaners Corp., 38 A.D.2d 743, 329 N.Y.S.2d 350, 10 U.C.C. Rep. Serv. 160 (2d Dep't 1972).

2 Elliott v. Brady, 192 N.Y. 221, 85 N.E. 69 (1908).

3 Elliott v. Brady, 192 N.Y. 221, 85 N.E. 69 (1908).

4 Standard Finance Co., Ltd. v. Ellis, 3 Haw. App. 614, 657 P.2d 1056, 35 U.C.C. Rep. Serv. 864 (1983).

Works.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

5. Fraud

§ 524. Fraud in transfer or negotiation of instrument as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 103(1), 380, 452(4)

A holder in due course takes the instrument free from all claims to it on the part of any person,[1] so that fraud in the transfer of an instrument is not available as a defense against a holder in due course.[2] Such fraud is, however, a defense against one who is not a holder in due course.[3]

Footnotes

1 § 495.

2 Official Comment 3 to U.C.C. § 3-202 [2002].

3 Mitchell v. Colonial Trust Co., 41 N.Y.S.2d 562 (N.Y. City Ct. 1943).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

5. Fraud

§ 525. Fraud on accommodation party or surety as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 103(1), 452(4)

Generally, an accommodation party is not liable to a holder for value who has participated in, or has had notice of, fraud on such party.[1] However, an accommodation party may not, on the ground of fraud inducing him or her to sign the instrument, avoid liability to a holder in due course of the accommodation paper or a holder for value without notice of the fraud, including the payee.[2] Thus, an accommodation indorser is liable to the payee of a note, even though the indorsement was procured by fraud and misrepresentation, where the payee is not charged with having knowledge of, or as having any part in, the fraud and misrepresentation.[3]

It is not a defense to an action by a payee, or his or her assignee, against an accommodation maker that the payee knew the nature of the defendant's obligation and failed to disclose the fact that he or she had been unable to obtain payment on earlier past-due notes executed by the accommodated party. The very fact that a loan was refused upon the personal obligation of such party is, in itself, sufficient to put the accommodation party on notice that the accommodated party's financial responsibility was questioned by the lenders.[4]

An accommodation maker may present the defense of fraud in the factum where the bank fails to explain the nature of the transaction to the accommodation maker, the accommodation maker does not understand that he or she was assuming any financial responsibility upon signing the note, and the maker of the note falsely and fraudulently misrepresents the document.[5]

Footnotes

1 Wiesenthal v. Krane, 226 A.D. 82, 234 N.Y.S. 392 (1st Dep't 1929).

[2] Thompson v. Franklin Nat. Bank, 45 App. D.C. 218, 1916 WL 21576 (App. D.C. 1916); Potts v. First State Bank of Talihina, 1915 OK 620, 51 Okla. 162, 151 P. 859 (1915).
As to the defenses available to an accommodation party, generally, see § 499.

[3] Treadwell v. Exchange Nat. Bank of Tampa, 127 Fla. 40, 172 So. 914 (1937).

[4] Conlew, Inc. v. Uhler, 239 A.D. 380, 267 N.Y.S. 596 (1st Dep't 1933).

[5] United Bank & Trust Co. of Maryland v. Schaeffer, 280 Md. 10, 370 A.2d 1138, 21 U.C.C. Rep. Serv. 586 (1977).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

a. In General; Unauthorized Signature; Fraudulent Indorsement

§ 526. Unauthorized signature or fraudulent indorsement as defense to action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 54, 61, 123(1) to 123(3), 279

A.L.R. Library

Payee's and Drawer's Right of Recovery, in Conversion Under Pre-1990 U.C.C. s3-419, or Post-1990 U.C.C. s3-420 [Rev], for Money Paid on Unauthorized Indorsement, 91 A.L.R.5th 89

Falsifying of money order as forgery, 65 A.L.R.3d 1307

Right of check owner to recover against one cashing it on forged or unauthorized indorsement and procuring payment by drawee, 100 A.L.R.2d 670

Right and remedy of drawer of check against collecting bank which receives it on forged indorsement and collects it from drawee bank, 99 A.L.R.2d 637

When statute of limitations starts to run against depositor's cause of action against bank to recover funds paid out on check bearing forged indorsement, 82 A.L.R.2d 933

Who must bear loss as between drawer or indorser who delivers check to an impostor and one who purchases, cashes, or pays it upon the impostor's indorsement, 81 A.L.R.2d 1365

Alteration of figures indicating amount of check, bill, or note, without change in written words, as forgery, 64 A.L.R.2d 1029

Trial Strategy

Cause of Action Against Bank for Payment of Check over Unauthorized or Missing Endorsement, 11 Causes of Action 143

Forms

Forms relating to denial of execution or indorsement, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

In general, a person is not liable on a negotiable instrument unless the person signed the instrument, or the person is represented by an agent or representative who signed the instrument and the signature is binding on the represented person.[1] An unauthorized signature is ineffective except as to the signature of the unauthorized signer in favor of a person who, in good faith, pays the instrument or takes it for value. An unauthorized signature may be ratified for all purposes of Revised Article 3.[2]

Observation:

In general, the Uniform Commercial Code provisions allocating losses due to the payment of unauthorized or fraudulent checks place the burden of loss on the party best able to prevent or to insure against the loss.[3]

Alleged procedural irregularities in a promissory note, namely that it is forged and not signed by the necessary corporate officers, makes it, at most, voidable, rather than void.[4]

Footnotes

1 U.C.C. § 3-401(a) [2002].
As to the liability of agents and principals on negotiable instruments, generally, see § 439.

2 U.C.C. § 3-403(a) [2002].
A lender did not take a note renewing the original loan to a borrower, a limited liability company (LLC), in good faith, within the meaning of the statute providing that "unauthorized signature is ineffective except as the signature of the unauthorized signer in favor of a person who in good faith pays the instrument or takes it for value," where the signatory testified that he had never been a member of the LLC borrower or affiliated with the borrower in any capacity, the borrower's owner also testified that the signatory had no affiliation with the borrower, and the lender had information in its possession confirming the owner as the borrower's sole owner and that the signatory had no involvement with the borrower. Davison v. Citizens Bank & Trust Company, 338 Ga. App. 671, 791 S.E.2d 437, 90 U.C.C. Rep. Serv. 2d 741 (2016).
As to an unauthorized signature operating as the signature of the unauthorized signer, see § 441.
As to ratification of an unauthorized signature, see § 540.
As to a failure to exercise ordinary care precluding a person from asserting that a signature was forged, see § 543.

[3] Unlimited Adjusting Group, Inc. v. Wells Fargo Bank, N.A., 174 Cal. App. 4th 883, 94 Cal. Rptr. 3d 672, 69 U.C.C. Rep. Serv. 2d 336 (2d Dist. 2009).

[4] Stoudemire v. HSBC Bank USA, 333 Ga. App. 374, 776 S.E.2d 483 (2015).

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Bills and Notes

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

a. In General; Unauthorized Signature; Fraudulent Indorsement

§ 527. Forged or unauthorized signature as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 377

A.L.R. Library

Discharge of debtor who makes payment by delivering check payable to creditor to latter's agent, where agent forges creditor's signature and absconds with proceeds, 49 A.L.R.3d 843

Treatises and Practice Aids

As to unauthorized signatures, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to forged or unauthorized signatures, generally, see Am. Jur. Pleading and Practice Forms, Commercial

Code [Westlaw®(r) Search Query]

Thus, a person cannot be held liable on an instrument unless he or she has signed the instrument or it has been signed for the person by an authorized agent. No liability on the instrument can be imposed on the basis of an oral promise to pay the instrument or on a promise made in another writing or letter.[1] The purported maker of a negotiable instrument may raise forgery as a defense to an obligation on the instrument held by a party claiming holder-in-due-course status.[2]

Observation:

With respect to forged checks, the Code initially places the risk of forgeries on banks, in that a forged signature is wholly inoperative as that of the person whose name is signed, the check is not properly payable, and the bank cannot debit the depositor's account.[3] Although the Code imposes on the customer the duty to inspect its statement and canceled checks with reasonable care and promptness, the loss of repeated forgeries is shifted back to the bank when the customer, although in breach of its duty of inspection, is able to establish that the bank lacked ordinary care in paying the forged checks.[4]

Footnotes

1 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-401:3 (3d ed.).

2 Liberty Mortgage Corporation v. Fiscus, 2016 CO 31, 379 P.3d 278, 89 U.C.C. Rep. Serv. 2d 815 (Colo. 2016).

3 Putnam Rolling Ladder Co., Inc. v. Manufacturers Hanover Trust Co., 74 N.Y.2d 340, 547 N.Y.S.2d 611, 546 N.E.2d 904, 10 U.C.C. Rep. Serv. 2d 14 (1989).

4 Putnam Rolling Ladder Co., Inc. v. Manufacturers Hanover Trust Co., 74 N.Y.2d 340, 547 N.Y.S.2d 611, 546 N.E.2d 904, 10 U.C.C. Rep. Serv. 2d 14 (1989).
As to the effect of the failure of a bank to follow reasonable commercial practices, see § 544.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

a. In General; Unauthorized Signature; Fraudulent Indorsement

§ 528. What constitutes forged or unauthorized signature on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 377

A.L.R. Library

Implied or apparent authority of agent to purchase or order goods or merchandise, 55 A.L.R.2d 6

Authority of agent to indorse and transfer commercial paper, 37 A.L.R.2d 453

Forms

Forms relating to forged or unauthorized signatures, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Under the Uniform Commercial Code, an "unauthorized" signature means one made without actual, implied, or apparent authority, and includes a forgery.[1] It also includes a signature made by one exceeding his or her actual or apparent authority.[2]

An indorsement of the payee's signature on a draft issued by an insurance company to both the payee and the payee's attorney in settlement of an insurance claim, which was made by the payee's attorney without the payee's authorization, is a

forgery.[3] However, where the maker signs notes with loan amounts left blank prior to the time the maker discontinues doing business with the bank, and someone without authority later fills in dates and amounts on the notes, the signatures are not unauthorized signatures which constitute forgery, and the holder in due course can enforce the notes as completed.[4]

Footnotes

1 U.C.C. § 1-201(41)[2001].

2 Official Comment 1 to U.C.C. § 3-403 [2002].

3 Smith v. General Cas. Co. of Wisconsin, 75 Ill. App. 3d 971, 31 Ill. Dec. 602, 394 N.E.2d 804, 27 U.C.C. Rep. Serv. 493 (3d Dist. 1979).

4 National Loan Investors, L.P. v. Martin, 488 N.W.2d 163, 19 U.C.C. Rep. Serv. 2d 193 (Iowa 1992).

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B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

a. In General; Unauthorized Signature; Fraudulent Indorsement

§ 529. Liability of unauthorized signer on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 377

Treatises and Practice Aids

As to liability of unauthorized signer, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to liability of signer, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Except as otherwise provided, an unauthorized signature is ineffective as the signature of the person whose name is signed. As a result, the person whose name is signed is not liable on the instrument. In addition, since an unauthorized indorsement will not operate to negotiate the instrument, no transferee following the unauthorized indorsement can be a holder.[1] Rather, any unauthorized signature operates as the signature of the unauthorized signer in favor of any person who, in good faith, pays the instrument or takes it for value.[2]

Comment:

The unauthorized signature, while wholly inoperative as that of the person whose name is signed, is effective to impose liability upon the signer or to transfer any rights that he or she may have in the instrument. The signer's liability is not in damages for breach of a warranty of authority, but is full liability on the instrument in the capacity in which he or she has signed. It is, however, limited to parties who take or pay the instrument in good faith; and one who knows that the signature is unauthorized cannot recover from the signer on the instrument.[3]

For example, in an action by a check-cashing agency against a trucking company to recover funds it disbursed to an administrative assistant of the trucking company, who had stolen eight company checks from the trucking company's offices and made out the checks to herself in various amounts, the check-cashing agency could not recover from the trucking company because the signatures on the checks presented by the administrative assistant to the check-cashing agency were plainly unauthorized, and the unauthorized signatures were ineffective against all parties except the forger. The check-cashing agency's recourse was against the wrongdoer who had fraudulently made out the checks.[4]

Footnotes

1 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-403:3 (3d ed.).

2 U.C.C. § 3-403(a) [2002].

3 Official Comment 2 to U.C.C. § 3-403 [2002].

4 Money Stop Financial Services v. AFT Trucking, LLC, 62 U.C.C. Rep. Serv. 2d 301 (N.J. Super. Ct. App. Div. 2007).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

a. In General; Unauthorized Signature; Fraudulent Indorsement

§ 530. Signature by impostor as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 239, 279, 377, 381

A.L.R. Library

Construction and application of U.C.C. sec. 3-405(1)(a) involving issuance of negotiable instrument induced by impostor, 92 A.L.R.3d 608

Who must bear loss as between drawer or indorser who delivers check to an impostor and one who purchases, cashes, or pays it upon the impostor's indorsement, 81 A.L.R.2d 1365

Forms

Forms relating to imposter/impostor, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

If an impostor, by use of the mails or otherwise, induces the issuer of a negotiable instrument to issue the instrument to the impostor, or to a person acting in concert with the impostor, by impersonating the payee of the instrument or a person authorized to act for the payee, an indorsement of the instrument by any person in the name of the payee is effective as the

indorsement of the payee in favor of a person who, in good faith, pays the instrument or takes it for value or for collection.[1] An indorsement is made in the name of a payee if (1) it is made in a name substantially similar to that of the payee, or (2) the instrument, whether or not indorsed, is deposited in a depositary bank to an account in a name substantially similar to that of the payee.[2]

The policy of the Code is to place the loss on the bank that dealt with the forger on the theory that it was best able to detect and prevent the wrongdoing.[3] Where a check is delivered to an impostor as payee and the drawer believes that the impostor is the person on whose indorsement it will be paid, an indorsement by the impostor in the name being used to impersonate another is not a forgery.[4]

In cases governed by the above Code provision, the dispute will normally be between the drawer of the check that was obtained by the impostor and the drawee bank that paid it. The drawer is precluded from obtaining recredit of the drawer's account by arguing that the check was paid on a forged indorsement so long as the drawee bank acted in good faith in paying the check. If a check payable to an impostor is paid, the effect of the Code provision is to place the loss on the drawer of the check rather than on the drawee or the depositary bank that took the check for collection. These cases always involve fraud; the drawer is in the best position to avoid the fraud, and thus should take the loss. However, in some cases, the person taking the check might have detected the fraud, and thus have prevented the loss by the exercise of ordinary care. In those cases, if that person failed to exercise ordinary care, it is reasonable that that person bear the loss to the extent the failure contributed to the loss.[5] Thus, if a person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure contributes to loss resulting from payment of the instrument, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.[6]

The "impostor" rule codified in the Code provisions applies only when the issuance of the instrument has been accomplished through impersonation of the payee, whether the perpetrator of the deception pretends to be the principal, that is, the payee, or an agent.[7]

Footnotes

1 U.C.C. § 3-404(a) [2002].

2 U.C.C. § 3-404(c) [2002], referring to U.C.C. § 3-404(a), (b) [2002].

3 In re Lou Levy & Sons Fashions, Inc., 988 F.2d 311, 19 U.C.C. Rep. Serv. 2d 1107 (2d Cir. 1993); Dominion Bank, N.A. v. Household Bank, F.S.B., 827 F. Supp. 463, 23 U.C.C. Rep. Serv. 2d 781 (S.D. Ohio 1993).
The rationale of the allocation of loss made by Article 3 is to place the loss on the party the better able to have prevented the loss. Menichini v. Grant, 995 F.2d 1224, 20 U.C.C. Rep. Serv. 2d 959 (3d Cir. 1993).

4 Guaranty Bank & Trust Co. v. Federal Reserve Bank of Kansas City, 454 F. Supp. 488, 24 U.C.C. Rep. Serv. 932 (W.D. Okla. 1977) (stating that the definition of "impostor" does not extend to a false representation that the borrower was an authorized agent of the check's payee); Title Ins. Co. v. Comerica Bank - California, 27 Cal. App. 4th 800, 32 Cal. Rptr. 2d 735, 24 U.C.C. Rep. Serv. 2d 584 (6th Dist. 1994).

5 Official Comment 3 to U.C.C. § 3-404 [2002].

6 U.C.C. § 3-404(d) [2002].
For purposes of the statute governing the liability of parties when an imposter indorses a negotiable instrument, a check-cashing company did not fail to exercise "ordinary care" when it cashed a check for an imposter, who fraudulently obtained a loan from the check's issuer, and thus the default allocation of loss to the issuer under the imposter rule did not shift to the company, though the company failed to ask the imposter for his thumbprint, as the company examined the same driver's license and loan documents that the issuer found satisfactory in issuing the check to the imposter. State Sec. Check Cashing, Inc. v. American General Financial Services (DE), 409 Md. 81, 972 A.2d 882, 69 U.C.C. Rep. Serv. 2d 683 (2009).
As to the application of this provision to cases involving fictitious payees and payees not intended to have an interest in the instrument, see § 533.

As to the similar provision with respect to a fraudulent indorsement made by an employee with responsibility for the instrument, see § 532.

[7] Title Ins. Co. v. Comerica Bank - California, 27 Cal. App. 4th 800, 32 Cal. Rptr. 2d 735, 24 U.C.C. Rep. Serv. 2d 584 (6th Dist. 1994).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

a. In General; Unauthorized Signature; Fraudulent Indorsement

§ 531. Signature in representative capacity as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 123(2)

Forms

Forms relating to signature by representative, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Principals are liable on negotiable instruments when the principal's agent, acting as an agent, signs the instrument and has common-law authority to do so.[1] Where it is apparent from a promissory note that the true object and intent of its execution is to bind the principal, and not the agent, courts will adopt that construction of it.[2] Whether a note has been executed by a party in his or her individual or representative capacity is a question to be determined from the consideration of the whole instrument.[3]

Footnotes

1 Soults Farms, Inc. v. Schafer, 797 N.W.2d 92, 74 U.C.C. Rep. Serv. 2d 619 (Iowa 2011).

2 Orum Stair, LLC v. GJJG Ents., LLC, 2016-Ohio-7064, 72 N.E.3d 190 (Ohio Ct. App. 10th Dist. Franklin County 2016).

An individual who executed a promissory note on behalf of a corporate obligor under the promissory note was not personally liable on such note, where the individual's signature was preceded by the name of the corporation and followed by the individual's job title. Williams v. Bell, 402 S.W.3d 28 (Tex. App. Houston 14th Dist. 2013).

Under New York law, a signatory of a dishonored check who failed to indicate on the face of the check that he signed in a representative capacity may escape personal liability where there is an understanding, implicit in the course of dealing between the parties, that he was acting in a representative capacity; however, unless the defendant makes an affirmative demonstration that the taker of the note knew or understood that the signer intended to execute the instrument in a representative status only, there can be no defense that, notwithstanding the form of the note, representative liability was otherwise established between the parties. Finkel v. Romanowicz, 577 F.3d 79, 70 U.C.C. Rep. Serv. 2d 118 (2d Cir. 2009).

[3] Schaffer v. First Merit Bank, N.A., 186 Ohio App. 3d 173, 2009-Ohio-6146, 927 N.E.2d 15 (9th Dist. Lorain County 2009).

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B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

a. In General; Unauthorized Signature; Fraudulent Indorsement

§ 532. Fraudulent indorsement made by employee with responsibility for negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 201, 239, 279, 452(4)

A.L.R. Library

Construction and effect of "padded payroll" rule of U.C.C. sec. 3-405, 45 A.L.R.5th 389

For the purpose of determining the rights and liabilities of a person who, in good faith, pays an instrument or takes it for value or for collection, if an employer entrusted an employee with responsibility with respect to the instrument and the employee or a person acting in concert with the employee makes a fraudulent indorsement of the instrument, the indorsement is effective as the indorsement of the person to whom the instrument is payable if it is made in the name of that person.[1]

Under the section of the Texas Uniform Commercial Code governing an employer's responsibility for fraudulent indorsement by an employee, the bank must bear the burden of proving the first three elements, that is, that the bank acted in good faith, that the embezzler was an employee entrusted with responsibility for the check, and that the check was fraudulently indorsed, and once the bank meets this burden, the burden shifts to the employer to present evidence raising a fact issue on whether the bank failed to exercise ordinary care with respect to the check.[2] However, if the person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure contributes to loss resulting from the fraud, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.[3]

Definitions:

"Employee" includes an independent contractor and employee of an independent contractor retained by the employer.[4]

"Responsibility" with respect to instruments means the authority to do any of the following:

- to sign or indorse instruments on behalf of the employer
- to process instruments received by the employer for bookkeeping purposes, for deposit to an account, or for other disposition
- to prepare or process instruments for issue in the name of the employer
- to supply information determining the names or addresses of payees of instruments to be issued in the name of the employer
- to control the disposition of instruments to be issued in the name of the employer
- to act otherwise with respect to instruments in a responsible capacity[5]

"Responsibility" does not include authority that merely allows an employee to have access to instruments or blank or incomplete instrument forms that are being stored or transported or are part of incoming or outgoing mail, or similar access.[6]

"Fraudulent indorsements" means in the case of an instrument payable to the employer a forged indorsement purporting to be that of the employer, or in the case of an instrument with respect to which the employer is the issuer, a forged indorsement purporting to be that of the person identified as payee.[7]

Comment:

This section is addressed to fraudulent indorsements made by an employee with respect to instruments with respect to which the employer has given responsibility to the employee. It covers two categories of fraudulent indorsements; indorsements made in the name of the employer to instruments payable to the employer and indorsements made in the name of payees of instruments issued by the employer. This section applies to instruments generally but normally the instrument will be a check. It adopts the principle that the risk of loss for fraudulent indorsements by employees who are entrusted with responsibility with respect to checks should fall on the employer rather than the bank that takes the check or pays it, if the bank was not negligent in the transaction. It is based on the belief that the employer is in a far better position to avoid the loss by care in choosing employees, in supervising them, and in adopting other measures to prevent forged indorsements on instruments payable to the employer or fraud in the issuance of instruments in the name of the employer. If the bank failed to exercise ordinary care, the employer may shift loss to the bank to the extent the bank's failure to exercise ordinary care contributed to the loss. The provision applies regardless of whether the employer is negligent.[8]

In addition to the above Code provision, the provision respecting the effect of a signature in the name of a fictitious payee or payee intended to have no interest in the instrument also applies to cases of employee fraud.[9]

Footnotes

1 U.C.C. § 3-405(b) [2002].

2 Coastal Agricultural Supply, Inc. v. JP Morgan Chase Bank, N.A., 759 F.3d 498, 84 U.C.C. Rep. Serv. 2d 165 (5th Cir. 2014).

3 U.C.C. § 3-405(b) [2002].

[4] U.C.C. § 3-405(a)(1) [2002].

[5] U.C.C. § 3-405(a)(3) [2002].
As to when an indorsement is made in the name of the person to whom an instrument is payable, see § 533.

[6] U.C.C. § 3-405(a)(3) [2002].

[7] U.C.C. § 3-405(a)(2) [2002].

[8] Official Comment 1 to U.C.C. § 3-405 [2002].
As to the effect of a failure to exercise ordinary care that contributes to the making of a forged signature, see § 543.

[9] Official Comment 3 to U.C.C. § 3-405 [2002], referring to U.C.C. § 3-404(b).
As to the effect of a signature in the name of a fictitious payee or payee intended to have no interest in the instrument, see § 533.

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B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

a. In General; Unauthorized Signature; Fraudulent Indorsement

§ 533. Signature in name of fictitious payee or payee intended to have no interest in negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 239, 279, 381

A.L.R. Library

Bills and notes: nominal payee rule of U.C.C. sec. 3-405(1)(b), 92 A.L.R.3d 268

Forms

Forms relating to intending interest, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

If a person whose intent determines to whom an instrument is payable does not intend the person identified as payee to have any interest in the instrument, or the person identified as payee of an instrument is a fictitious person, the following rules apply until the instrument is negotiated by special indorsement. In both of those cases, until the instrument is negotiated by special indorsement, any person in possession of the instrument is its holder, and an indorsement by any person in the name of the payee stated in the instrument is effective as the indorsement of the payee in favor of a person who, in good faith, pays

the instrument or takes it for value or for collection.[1]

An indorsement is made in the name of a payee if (1) it is made in a name substantially similar to that of the payee, or (2) the instrument, whether or not indorsed, is deposited in a depositary bank to an account in a name substantially similar to that of the payee.[2]

This Code provision applies to any instrument, but its primary importance is with respect to checks of corporations and other organizations. It also applies to forged check cases.[3] Although this provision is not limited to such cases, most of the cases to which it applies will be cases of employee fraud.[4]

If a check payable to a fictitious payee or a payee not intended to have an interest in the check is paid, the effect of the above Code provision is to place the loss on the drawer of the check rather than on the drawee or the depositary bank that took the check for collection. These cases almost always involve fraud; the drawer is in the best position to avoid the fraud, and thus should take the loss. However, in some cases, the person taking the check might have detected the fraud, and thus, have prevented the loss by the exercise of ordinary care. In those cases, if that person failed to exercise ordinary care, it is reasonable that that person bear loss to the extent the failure contributed to the loss.[5] Thus, if a person paying the instrument or taking it for value or for collection fails to exercise ordinary care in paying or taking the instrument and that failure contributes to loss resulting from payment of the instrument, the person bearing the loss may recover from the person failing to exercise ordinary care to the extent the failure to exercise ordinary care contributed to the loss.[6]

Comment:

Cases involving checks payable to a fictitious payee or a payee not intended to have an interest in the check are often forged check cases as well. Normally, the loss in forged check cases is on the drawee bank that paid the check. The doctrine that prevents a drawee bank from recovering payment with respect to a forged check if the payment was made to a person who took the check for value and in good faith is incorporated into provisions of the Uniform Commercial Code.[7] This doctrine is based on the assumption that the depositary bank, normally, has no way of detecting the forgery, because the drawer is not that bank's customer. On the other hand, the drawee bank, at least in some cases, may be able to detect the forgery by comparing the signature on the check with the specimen signature that the drawee has on file. However, in some forged check cases the depositary bank is in a position to detect the fraud. Those cases typically involve a check payable to a fictitious payee or a payee not intended to have an interest in the check. U.C.C. § 3-404(d) [2002] applies to those cases.[8]

The fictitious payee defense operated to shield the collecting bank from liability to the drawer whose employee had induced the drawer to issue checks, supplied the name of payee, intended that the named payee had no interest in the checks, procured the checks, fraudulently endorsed them for deposit into his account at the collecting bank, and subsequently was permitted to withdraw from his account all funds representing such checks.[9]

The fictitious payee rule cannot be circumvented by claims for conversion and for money had and received.[10]

Footnotes

1 U.C.C. § 3-404(b) [2002], referring to U.C.C. § 3-110(a), (b) [2002].

2 U.C.C. § 3-404(c) [2002].

3 Official Comment 2 to U.C.C. § 3-404 [2002], also giving several illustrative cases.

[4] Official Comment 3 to U.C.C. § 3-405 [2002].
As to a fraudulent indorsement made by an employee with responsibility for an instrument, see § 532.

[5] Official Comment 3 to U.C.C. § 3-404 [2002].

[6] U.C.C. § 3-404(d) [2002].

[7] U.C.C. § 3-417(a)(3) [2002]; U.C.C. § 4-208(a)(3) [2002]; U.C.C. § 3-418 [2002].

[8] Official Comment 3 to U.C.C. § 3-404 [2002].
As to the application of U.C.C. § 3-404(d) [2002] to cases involving impostors, see § 530.
As to the similar provision with respect to a fraudulent indorsement made by an employee with responsibility for the instrument, see § 532.

[9] Shearson Lehman Bros., Inc. v. Wasatch Bank, 788 F. Supp. 1184, 18 U.C.C. Rep. Serv. 2d 208 (D. Utah 1992).

[10] Prudential-Bache Securities, Inc. v. Citibank, N.A., 73 N.Y.2d 263, 539 N.Y.S.2d 699, 536 N.E.2d 1118, 7 U.C.C. Rep. Serv. 2d 1345 (1989).

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12 Am. Jur. 2d Bills and Notes § 534

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Bills and Notes
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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

a. In General; Unauthorized Signature; Fraudulent Indorsement

§ 534. Absence of required signature as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 54

If the signature of more than one person is required to constitute the authorized signature of an organization, the signature of the organization is unauthorized if one of the required signatures is lacking.[1]

Comment:

This Uniform Commercial Code provision clarifies the meaning of "unauthorized" in cases in which an instrument contains fewer than all of the signatures that are required as authority to pay a check. It resolves a split in judicial authority by following the line of cases holding that it is the customer's signature at issue, not the authenticity of any individual signature appearing on the instrument; hence, the customer's signature is unauthorized if not all signatures required to authorize payment of the check are on the check. The same result occurs if one of the required signers forges the signature of another required signer. Because the forgery is not effective as a signature of the latter, the required signature of the latter is lacking.[2]

The provision refers to "the authorized signature of an organization." The Code definition of "organization" is very broad. It covers not only commercial entities but also "two or more persons having a joint or common interest."[3] Under this broad definition of "organization," the above Code provision would apply when a husband and wife are both required to sign a negotiable instrument.[4]

Absence of a signature required to make a withdrawal constitutes an "unauthorized signature," for purposes of the U.C.C. provision defining unauthorized signatures of organizational account holders.[5]

Where two signatures are required for payment of an item, the absence of one of the signatures constitutes an "unauthorized signature" for the purposes of the provision of the U.C.C. concerning ineffectiveness of an unauthorized signature, and unless excused, the bank bears liability for payment of an instrument bearing such an unauthorized signature.[6] A bank was sued by a corporate customer's insurer after the insurer had paid embezzlement losses sustained by the corporation as a result of the bank's payment of checks drawn on the corporation's accounts that did not contain two handwritten signatures of authorized persons as required by corporate resolutions submitted on forms furnished by the bank. These resolutions stated that they were to remain in effect until written notice of their rescission or amendment had been received by the bank. Although the resolutions required two handwritten signatures for checks over a certain amount, the comptroller of the corporation, who was one of the authorized signers and devised the embezzlement plan, subsequently advised the bank by telephone that it should pay checks bearing one handwritten and one facsimile signature. Since there was no evidence that the comptroller had the actual or apparent authority to permit the bank to deviate from the two-hand-signature condition in the corporate resolution and since there was nothing to show that the corporation ratified the payment of the checks, the bank was liable to the corporation's subrogated insurer.[7]

Footnotes

1 U.C.C. § 3-403(b) [2002].

2 Official Comment 4 to U.C.C. § 3-403 [2002].

3 Official Comment 4 to U.C.C. § 3-403 [2002].

4 Official Comment 4 to U.C.C. § 3-403 [2002].

5 Dow City Cemetery Ass'n v. Defiance State Bank, 596 N.W.2d 77, 38 U.C.C. Rep. Serv. 2d 1267 (Iowa 1999) (referring to U.C.C. § 3-403(b) [2002]).

6 Fackrell v. American Nat. Bank, 2005 OK CIV APP 37, 116 P.3d 201 (Div. 3 2005) (referring to U.C.C. § 3-403(b) [2002]).

7 Federal Ins. Co. v. NCNB Nat. Bank of North Carolina, 958 F.2d 1544, 17 U.C.C. Rep. Serv. 2d 497 (11th Cir. 1992).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

b. Alteration and Unauthorized Completion

§ 535. Alteration and unauthorized completion as defense to action on negotiable instrument, generally; materiality of alteration

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 136, 378, 452(1)

A.L.R. Library

What constitutes "fraudulent and material" alteration of negotiable instrument under U.C.C. sec. 3-407(2)(a), 88 A.L.R.3d 905

Treatises and Practice Aids

As to alteration defined, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to material alteration, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Forms relating to alteration, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

"Alteration" means an unauthorized change in an instrument that purports to modify in any respect the obligation of a party, or an unauthorized addition of words or numbers or other change to an incomplete instrument relating to the obligation of a party.[1]

An alteration is either an unauthorized change to the instrument that purports to modify, in any respect, the obligation of any party thereto, or an unauthorized completion of an incomplete instrument. Any such change to an instrument is an alteration, whether or not the change is material. However, a change that merely reflects the underlying agreement does not alter the instrument.[2] An alteration may consist of a change in the sum payable, the date of execution, the date of payment, the number or amount of installments, the place of payment, the medium of payment, or the name of the payee.[3] To constitute an alteration, the change must be made to the instrument itself.[4]

A check is altered and not forged when a payee's name is changed from one name to another since an alteration is an unauthorized change in an instrument that purports to modify the obligation of a party.[5] A counterfeit or fake check, as opposed to the modification of an existing check, does not meet the definition of alteration. An counterfeit check is not an alteration of an existing check but an entirely new instrument.[6] Thus, a forged check presented to a drawee bank, which was a copy of the original check from the drawer, but with the name of the payee, the amount, and the date changed on the copy, did not involve an alteration of the original instrument and instead involved an alteration of a copy of the original instrument, and thus a depository bank did not owe a warranty to a drawee bank, under the U.C.C., that the draft presented for payment had not been altered.[7]

The defense of alteration may only be raised by a party to the instrument.[8]

Footnotes

1 U.C.C. § 3-407(a) [2002].
Placement of an undated blank indorsement on the original promissory note after a copy of the note was attached to the mortgagee's verified foreclosure complaint was not an "alteration" of the note within the meaning of the Uniform Commercial Code, and thus did not affect the authenticity or admissibility of the note; there was no evidence that the indorsement was unauthorized or that it purported to modify the obligations of any party, the indorsement was superfluous, since there already existed an allonge indorsing the note from the original lender to the mortgagee, and there was no evidence of fraudulent purpose. U.S. Bank National Association for BAFC 2007-4 v. Roseman, 214 So. 3d 728, 92 U.C.C. Rep. Serv. 2d 159 (Fla. 4th DCA 2017).

2 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:4 (3d ed.).

3 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:4 (3d ed.).

4 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:4 (3d ed.).

5 Wachovia Bank, N.A. v. Foster Bancshares, Inc., 59 U.C.C. Rep. Serv. 2d 828 (N.D. Ill. 2005), aff'd, 457 F.3d 619, 60 U.C.C. Rep. Serv. 2d 1126 (7th Cir. 2006).

6 Bank of America, N.A. v. Amarillo Nat. Bank, 156 S.W.3d 108, 55 U.C.C. Rep. Serv. 2d 496 (Tex. App. Amarillo 2004).

7 Bank of America, N.A. v. Amarillo Nat. Bank, 156 S.W.3d 108, 55 U.C.C. Rep. Serv. 2d 496 (Tex. App. Amarillo

2004).

[8] Delta Bank and Trust Co. v. Chisholm, 601 So. 2d 345, 19 U.C.C. Rep. Serv. 2d 514 (La. Ct. App. 5th Cir. 1992).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

b. Alteration and Unauthorized Completion

§ 536. Unauthorized completion as material alteration to negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 136, 378, 452(1)

Treatises and Practice Aids

As to unauthorized completion, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to unauthorized alteration, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

An "incomplete instrument" means a signed writing, whether issued or not issued by the signer, the contents of which show at the time of signing that it is incomplete, but that the signer intended it to be completed by the addition of words or numbers.[1] If words or numbers are added to an incomplete instrument without authority of the signer, there is an alteration of the incomplete instrument.[2]

When the completion is authorized, the instrument is effective as completed. If the completion is unauthorized, whether, and

to what extent, the instrument may be enforced as determined by the statutory provision dealing with alteration.[3] Authority for completion of an incomplete instrument may be either express or implied. If the authority is express, the completion is authorized only if within the terms of the authority granted. Whether the holder has implied authority depends upon the state's law of agency. Where an instrument has been delivered with blanks or spaces, the holder has implied authority to complete the instrument according to his or her agreement with the obligor. The person asserting that a completion is unauthorized has the burden of so proving.[4] Whether there is express or implied authority is a question of fact to be determined by the non-U.C.C. law of agency.[5]

Footnotes

1 § 99.
As to the law governing incomplete instruments, generally, see §§ 99 to 102.

2 U.C.C. § 3-115(c) [2002], referring to U.C.C. § 3-407 [2002].

3 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-115:8 (3d ed.), referring to U.C.C. § 3-407.
As to the effect of alteration of a negotiable instrument, see § 539.

4 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-115:8 (3d ed.).

5 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-115:8 (3d ed.).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

b. Alteration and Unauthorized Completion

§ 537. Fraudulent intent required for alteration to provide discharge as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 136, 378

Treatises and Practice Aids

As to fraudulent alteration—fraudulent intent, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

In order for an alteration to provide a discharge, the alteration must have been made with a fraudulent intent.[1] An alteration that is not fraudulent has no effect upon any party's liability on the instrument. No party is discharged by a nonfraudulent alteration and the instrument may be enforced according to its original terms.[2] When an alteration to a check either does not change or lessen the obligation of the maker or other party, the alteration is not fraudulent under the U.C.C.[3] Consequently, notations made on an instrument by the bookkeeping department or other personnel to show that proper entries of a payment were made or to reflect the balance due on the instrument have no effect, as such alterations are not fraudulently made.[4]

An alteration should be found to be fraudulent only when the alteration was made with the intent to obtain an advantage to which the person making the alteration had reason to know he or she is not entitled.[5] An alteration is not fraudulent where the holder mistakenly believes that the party has authorized or consented to the alteration or completion or that she or he otherwise has the right to make the alteration.[6] Seldom will a change beneficial to the party whose contract has been affected be found to be fraudulent. Of course, if the alterer is attempting to obtain an advantage by a "beneficial" alteration, the result may be different.[7]

Comment:

Discharge because of alteration occurs only in the case of an alteration fraudulently made. There is no discharge if a blank is filled in the honest belief that it is authorized or if a change is made with a benevolent motive, such as a desire to give the obligor the benefit of a lower interest rate. Changes favorable to the obligor are unlikely to be made with any fraudulent intent, but if such intent is found the alteration may operate as a discharge.[8]

In a foreclosure action on real property that was mortgaged as security for loans secured from the plaintiff bank, even if the notes in question had been materially altered, the debtors, as guarantors, would not be discharged from their obligation inasmuch as the debtors failed to show that the bank had supplied additional terms or materially altered the notes for a fraudulent purpose.[9]

Footnotes

1 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:10 (3d ed.).

2 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:8 (3d ed.).

3 Cirrincione v. Westminster Gardens Ltd. Partnership, 352 Ill. App. 3d 755, 287 Ill. Dec. 763, 816 N.E.2d 730 (1st Dist. 2004).

4 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:8 (3d ed.).

5 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:10 (3d ed.).

6 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:101 (3d ed.).

7 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:10 (3d ed.).

8 Official Comment 1 to U.C.C. § 3-407 [2002].
As to the alteration of an instrument resulting in an obligor being discharged, see § 539.

9 Peacock v. Farmers and Merchants Bank, 454 So. 2d 730, 39 U.C.C. Rep. Serv. 937 (Fla. 1st DCA 1984).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

b. Alteration and Unauthorized Completion

§ 538. Alteration by consent as negating defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 136

A.L.R. Library

What constitutes "fraudulent and material" alteration of negotiable instrument under U.C.C. sec. 3-407(2)(a), 88 A.L.R.3d 905

Treatises and Practice Aids

As to nonfraudulent alteration, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Forms

Forms relating to alteration by consent, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r)

Search Query]

An alteration fraudulently made discharges a party whose obligation is affected by the alteration unless that party assents.[1] Thus, by definition, there is no alteration or improper completion within the Code when the parties affected by such action consent thereto.[2] Assent to an alteration given before or after it is made will prevent the party from asserting the discharge.[3]

The addition of a cosigner with the consent of the parties does not constitute an alteration.[4]

A party whose contract is affected by a fraudulent alteration is discharged from liability on the instrument, unless that party assents to the alteration or is precluded from asserting that the instrument has been altered.[5] Assent may be express or implied. The assent may be given before the alteration or after the alteration is made.[6] Even where a party does not expressly assent to an alteration, the party may be estopped from claiming a right to a discharge.[7]

Once a party, against whom the change would operate, consents to the change, the prior terms cease to exist and a holder can only sue on the paper as modified, with the result that, if the paper is usurious as modified, the usury sanctions are applicable and cannot be avoided by returning to the original terms of the paper.[8]

Footnotes

1 U.C.C. § 3-407(b) [2002].

2 Succession of Vidrine, 377 So. 2d 564 (La. Ct. App. 3d Cir. 1979).

3 Official Comment 1 to U.C.C. § 3-407 [2002].

4 Reagan v. City Nat. Bank, N.A., 714 S.W.2d 425, 2 U.C.C. Rep. Serv. 2d 537 (Tex. App. Eastland 1986), writ refused n.r.e., (Oct. 22, 1986).

5 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:9 (3d ed.).

6 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:12 (3d ed.).

7 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-407:12 (3d ed.).

8 Citizen's Nat. Bank of Willmar v. Taylor, 368 N.W.2d 913, 41 U.C.C. Rep. Serv. 516 (Minn. 1985).

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B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

b. Alteration and Unauthorized Completion

§ 539. Effect of alteration on defense of discharge of negotiable instrument; parties discharged

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 136, 378

Forms

Forms relating to alteration of instrument—answer—defenses, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Discharge is a personal defense of the party whose obligation is modified, and anyone whose obligation is not affected is not discharged. However, if an alteration discharges a party there is also discharge of any party having a right of recourse against the discharged party because the obligation of the party with the right of recourse is affected by the alteration.[1]

As an exception to the provision discharging a party whose obligation is affected by a fraudulently made alteration or unauthorized completion, the Uniform Commercial Code provides that a payor bank or drawee paying a fraudulently altered instrument or a person taking it for value, in good faith, and without notice of the alteration, may enforce rights with respect to the instrument according to its original terms or, in the case of an incomplete instrument altered by unauthorized completion, according to its terms as completed.[2]

Comment:

> Under the exception, a person paying a fraudulently altered instrument or taking it for value, in good faith, and without notice of the alteration, is not affected by a discharge under the Code. The person paying or taking the instrument may assert rights with respect to the instrument according to its original terms or, in the case of an incomplete instrument that is altered by unauthorized completion, according to its terms as completed. If blanks are filled or an incomplete instrument is otherwise completed, this exception places the loss upon the party who left the instrument incomplete by permitting enforcement in its completed form. This result is intended even though the instrument was stolen from the issuer and completed after the theft.[3]

A purchaser who takes an instrument with notice of any material alteration takes with notice of a claim or defense and cannot be a holder in due course.[4]

Footnotes

1 Official Comment 1 to U.C.C. § 3-407 [2002].

2 U.C.C. § 3-407(c) [2002].
As to the unauthorized completion of an instrument as a material alteration, see § 536.

3 Official Comment 2 to U.C.C. § 3-407 [2002].

4 §§ 235, 236.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

c. Preclusion of Defense

(1) Ratification; Estoppel

§ 540. Ratification as precluding defense to action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 61, 114

A.L.R. Library

What constitutes ratification of unauthorized signature under U.C.C. sec. 3-404, 93 A.L.R.3d 967

Treatises and Practice Aids

As to ratification of unauthorized signature, generally, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Trial Strategy

Ratification of Forged or Unauthorized Signature, 7 Am. Jur. Proof of Facts 2d 675 §§ 6 to 15 (Proof of ratification of

forged signature)

Forms

Forms relating to ratification of alteration, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Forms relating to ratification, generally, see Am. Jur. Pleading and Practice Forms, Banks; Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

An unauthorized signature may be ratified for all purposes of Revised Article 3.[1] This includes both an outright forgery and a signature by an agent in excess of his or her authority.[2]

Comment:

Ratification is a retroactive adoption of the unauthorized signature by the person whose name is signed and may be found from conduct as well as express statements. For example, it may be found from the retention of benefits received in the transaction with knowledge of the unauthorized signature.[3]

Ratification is effective for all purposes of Revised Article 3. The unauthorized signature becomes valid so far as its effect as a signature is concerned. Although the ratification may relieve the signer of liability on the instrument, it does not, of itself, relieve the signer of liability to the person whose name is signed. It does not in any way affect the criminal law. No policy of the criminal law prevents a person whose name is forged to assume liability to others on the instrument by ratifying the forgery, but the ratification cannot affect the rights of the state. While the ratification may be taken into account with other relevant facts in determining punishment, it does not relieve the signer of criminal liability.[4]

Although a forger is not an agent, ratification of an unauthorized signature is governed by the rules and principles applicable to ratification of unauthorized acts of an agent.[5]

Upon ratification, an unauthorized signature becomes valid so far as its effect as a signature is concerned.[6] Thus, ratification makes the signature effective as the signature of the purported principal and, therefore, it is no longer to be deemed the signature of the person signing.[7] This change resulting from ratification does not, however, alter the liability, if any, of the actual signer to the person whose name was signed.[8] Ratification is a definitive and irrevocable act and bars the victim ratifying from later complaining that the signing was a forgery.[9]

Footnotes

1 U.C.C. § 3-403(a) [2002].
As to a failure to exercise ordinary care precluding a person from asserting that a signature was forged, see § 543.

2 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-403:6 (3d ed.).

[3] Official Comment 3 to U.C.C. § 3-403 [2002].

[4] Official Comment 3 to U.C.C. § 3-403 [2002].

[5] Official Comment 3 to U.C.C. § 3-403 [2002].

[6] Official Comment 3 to U.C.C. § 3-403 [2002].

[7] Eggleston v. George Braun Packing Co., 470 S.W.2d 69, 9 U.C.C. Rep. Serv. 1084 (Tex. Civ. App. San Antonio 1971).

[8] Starkey Const., Inc. v. Elcon, Inc., 248 Ark. 958, 248 Ark. 978A, 457 S.W.2d 509, 7 U.C.C. Rep. Serv. 923 (1970); Rakestraw v. Rodrigues, 8 Cal. 3d 67, 104 Cal. Rptr. 57, 500 P.2d 1401, 11 U.C.C. Rep. Serv. 780 (1972).

[9] Fulka v. Florida Commercial Banks, Inc., 371 So. 2d 521, 26 U.C.C. Rep. Serv. 1198 (Fla. 3d DCA 1979).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

c. Preclusion of Defense

(1) Ratification; Estoppel

§ 541. What constitutes ratification of unauthorized signature on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 61, 114

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What constitutes ratification of unauthorized signature under U.C.C. sec. 3-404, 93 A.L.R.3d 967

Treatises and Practice Aids

As to ratification of unauthorized signature, generally, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Trial Strategy

Ratification of Forged or Unauthorized Signature, 7 Am. Jur. Proof of Facts 2d 675 §§ 6 to 15 (Proof of ratification of

forged signature)

Forms

Forms relating to ratification, generally, see Am. Jur. Pleading and Practice Forms, Banks; Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Ratification of an unauthorized signature may be found from conduct as well as from express statements; thus, it may be found from the retention of benefits received in the transaction with knowledge of the unauthorized signature.[1]

Ratification may be either express or implied. Express ratification requires an express statement adopting the signature as one's own. An implied ratification occurs where a person's conduct can only be explained or justified on the assumption that the person has adopted the signature as his or her own.[2] Ratification may be implied where a person retains the benefits or remains silent.[3] A person ratifies his or her signature where the person retains the proceeds of the instrument with full knowledge of all relevant facts or fails to object after full knowledge that the proceeds have been deposited into his or her bank account.[4] A person also ratifies his or her signature where the person remains silent under circumstances where a person who did not intend to ratify the signature would have informed the holder of the unauthorized signature. Silence constitutes ratification where it is explainable only on the theory that the party intended to adopt the signature as his or her own. However, some courts hold that any silence for more than a brief period of time constitutes ratification unless the person promptly renounces the unauthorized signature. However, the mere passage of time should not be found to be ratification unless the silence indicates an intention to ratify the signature.[5]

Practice Tip:

Ratification of a promissory note is a question of fact unless the evidence is undisputed and different inferences cannot reasonably be drawn from it, and a necessary element of ratification is intent.[6]

In any event, ratification requires knowledge of all material facts.[7] Ratification requires conduct to be consistent with an intent to affirm an unauthorized act and must be inconsistent with any other purpose.[8] Thus, a customer ratified payments when, during the course of eight months, a home aide for the 88-year-old customer induced the customer to sign numerous checks allegedly for the purpose of transferring money among the customer's several bank accounts or for the purchase of groceries. Instead, the home aide cashed the checks, made out either to herself or to cash, at the customer's banks, and pocketed all or most of the proceeds. The customer was present during the withdrawals and repeatedly expressed her authorization of the withdrawals when the tellers inquired.[9] On the other hand, an agreement by a former client whose settlement check had been fraudulently endorsed and deposited into a law firm's trust account to accept two-thirds of the settlement amount from the Lawyers' Fund for Client Protection was not a ratification of the law firm's forgery.[10]

The failure to repudiate an unauthorized indorsement by an agent within a reasonable time after learning of the transaction will be deemed a ratification.[11]

Footnotes

[1] Official Comment 3 to U.C.C. § 3-403 [2002].

[2] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-403:9 (3d ed.).

[3] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-403:9 (3d ed.).
Voluntarily retaining the benefits of a forged instrument amounts to a ratification of that instrument. Cherryvale Grain Co. v. First State Bank of Edna, 25 Kan. App. 2d 825, 971 P.2d 1204 (1999).

[4] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-403:9 (3d ed.).

[5] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-403:9 (3d ed.).

[6] U.S. Bank Nat. Ass'n v. Gutierrez, 136 A.D.3d 571, 25 N.Y.S.3d 206 (1st Dep't 2016).

[7] Bernardo v. Anello, 61 Ohio App. 3d 453, 573 N.E.2d 126 (8th Dist. Cuyahoga County 1988); Bank of Hoven v. Rausch, 382 N.W.2d 39, 42 U.C.C. Rep. Serv. 1359 (S.D. 1986).

[8] American Travel Corp. v. Central Carolina Bank & Trust Co., 57 N.C. App. 437, 291 S.E.2d 892, 34 U.C.C. Rep. Serv. 1233 (1982).

[9] U.S. v. Thomas, 315 F.3d 190, 49 U.C.C. Rep. Serv. 2d 337 (3d Cir. 2002) (abrogated on other grounds by, Loughrin v. U.S., 573 U.S. 351, 134 S. Ct. 2384, 189 L. Ed. 2d 411 (2014)) and (abrogated on other grounds by, United States v. Douglas, 885 F.3d 124 (3d Cir. 2018)).

[10] Lawyers' Fund for Client Protection of State of N.Y. v. Bank Leumi Trust Co. of New York, 94 N.Y.2d 398, 706 N.Y.S.2d 66, 727 N.E.2d 563, 40 U.C.C. Rep. Serv. 2d 930 (2000).

[11] Fort Dodge Creamery Co. v. Commercial State Bank, 417 N.W.2d 245, 5 U.C.C. Rep. Serv. 2d 666 (Iowa Ct. App. 1987).

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12 Am. Jur. 2d Bills and Notes § 542

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Bills and Notes

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

c. Preclusion of Defense

(2) Negligence

§ 542. Negligence as forged signature on or to alteration of negotiable instrument as precluding defenses, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 365(1), 377, 381

Treatises and Practice Aids

As to negligence contributing to forged signature or alteration of instrument, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Trial Strategy

Commercial Paper: Negligence Contributing to Alteration or Unauthorized Signature Under U.C.C. § 3-406, 14 Am. Jur. Proof of Facts 2d 693§§ 10 to 13

Forms

Forms relating to negligence, generally, see Am. Jur. Pleading and Practice Forms, Banks; Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

A person whose failure to exercise ordinary care substantially contributes to an alteration of a negotiable instrument or to the making of a forged signature on an instrument is precluded from asserting the alteration or the forgery against a person who, in good faith, pays the instrument or takes it for value or for collection.[1]

The preclusion rule can be asserted only by a person who satisfies the following two requirements. First, the person to be protected must have acted in good faith. Second, the person to be protected must have either paid the instrument or have taken it for value or for collection.[2]

Comment:

The Uniform Commercial Code[3] refers to a "forged signature" rather than to an "unauthorized signature" because it more accurately describes the scope of the provision. "Unauthorized signature" is a broader concept that includes not only forgery but also the signature of an agent which does not bind the principal under the law of agency. The agency cases are resolved independently under agency law. U.C.C. § 3-406 [2002] is not necessary in those cases.[4]

This Uniform Commercial Code provision adopts the doctrine of an English decision,[5] which held that a drawer who so negligently draws an instrument as to facilitate its material alteration is liable to a drawee who pays the altered instrument in good faith. The doctrine is expanded to apply not only to drafts but to all instruments. It includes in the protected class any "person who, in good faith, pays the instrument or takes it for value or for collection." The Code rejects decisions holding that the maker of a note owes no duty of care to the holder because at the time the instrument is issued there is no contract between them. By issuing the instrument and "setting it afloat upon a sea of strangers," the maker or drawer voluntarily enters into a relation with later holders which justifies imposition of a duty of care. In this respect, an instrument so negligently drawn as to facilitate alteration does not differ in principle from an instrument containing blanks which may be filled.[6]

The concept of "preclusion" preserves the concept of estoppel,[7] and this provision of the Code operates as a conditional estoppel which shields a bank from liability where a drawer's negligence substantially contributes to an alteration or forgery.[8]

The negligence that gives rise to the preclusion under this section may be the failure to maintain proper supervision over the wrongdoing agent.[9]

The provision governing negligence contributing to unauthorized signatures is not a substantive provision of tort liability.[10]

Comment:

Under another Code provision, U.C.C. § 3-407 [2002], a person paying an altered instrument or taking it for value, in good faith, and without notice of the alteration, may enforce rights with respect to the instrument according to its original terms. If negligence of the obligor substantially contributes to an alteration, the above Code provision gives the holder or the payor the alternative right to treat the altered instrument as though it had been issued in the altered form. In that case, the person taking the instrument is fully protected; the above general Code provision therefore does not make the negligent party liable in tort for damages resulting from the alteration.[11]

Footnotes

1 U.C.C. § 3-406(a) [2002].

2 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-406:23 (3d ed.).

3 U.C.C. § 3-406 [2002].

4 Official Comment 2 to U.C.C. § 3-406 [2002].
As to what constitutes a failure to exercise ordinary care, and the applicable standard of causation, see § 543.

5 Young v. Grote, 1827 WL 2974, (1827) 4 Bing. 253, 130 E.R. 764 (U.K. CCP 1827).

6 Official Comment 1 to U.C.C. § 3-406 [2002].

7 Cook v. Great Western Bank & Trust, 141 Ariz. 80, 685 P.2d 145, 39 U.C.C. Rep. Serv. 214 (Ct. App. Div. 1 1984).

8 Jacoby Transport Systems, Inc. v. Continental Bank, 277 Pa. Super. 440, 419 A.2d 1227, 28 U.C.C. Rep. Serv. 1398 (1980).

9 Lund v. Chemical Bank, 797 F. Supp. 259, 19 U.C.C. Rep. Serv. 2d 151 (S.D. N.Y. 1992).

10 National Bank of Fairhaven v. U.S., 660 F. Supp. 125, 4 U.C.C. Rep. Serv. 2d 131 (D. Mass. 1987).

11 Official Comment 1 to U.C.C. § 3-406 [2002].

12 Am. Jur. 2d Bills and Notes § 543

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

c. Preclusion of Defense

(2) Negligence

§ 543. What constitutes negligence that contributes to alteration of negotiable instrument or forged signature on instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 365(1), 377, 381

A.L.R. Library

Commercial paper: what amounts to "negligence contributing to alteration or unauthorized signature" under U.C.C. sec. 3-406, 67 A.L.R.3d 144

Treatises and Practice Aids

As to negligence contributing to forged signature or alteration of instrument, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

Trial Strategy

Commercial Paper: Negligence Contributing to Alteration or Unauthorized Signature Under U.C.C. § 3-406, 14 Am. Jur. Proof of Facts 2d 693§§ 14 to 26

Forms

Forms relating to negligence, generally, see Am. Jur. Pleading and Practice Forms, Banks; Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

The Uniform Commercial Code makes no attempt to define particular conduct that will constitute "failure to exercise ordinary care" that contributes to an alteration of a negotiable instrument or the making of a forged signature on the instrument.[1] Rather, Revised Article 3, respecting negotiable instruments, defines "ordinary care" in general terms; "ordinary care" in the case of a person engaged in business means the observance of reasonable commercial standards, prevailing in the area in which the person is located, with respect to the business in which the person is engaged.[2] In determining whether ordinary care has been exercised, the trier of fact should determine whether the party's actions were reasonable considering the foreseeability of the loss, the magnitude of the potential loss, and the cost of the means required to eliminate the risk of loss.[3] For example, evidence that bank customers hid a purse containing a checkbook under a sink, and attempted to take precautions to safeguard the checkbooks, automatic teller machine cards, and personal identification number from their daughter, was sufficient to establish the customers used ordinary care to prevent forgeries and unauthorized transactions on a checking account and savings/money market account by their daughter and that the customers did not substantially contribute to such forgeries and unauthorized transactions, for purposes of determining whether the customers were precluded from asserting the forgeries and unauthorized transactions against the bank.[4] Similarly, since a bank only established the possibility that a customer's relative might have had access to enter the bank customer's home without her permission, the customer was not precluded from recovering sums paid on checks forged by the customer's relative due to the customer's failure to exercise ordinary care in maintaining her account information and checkbooks prior to the forgery; although the bank presented evidence that the customer's relative might have had access to the checkbook on the account, the bank did not offer any evidence relating to how or when the checks were stolen.[5]

Comment:

The following cases illustrate the kind of conduct that can be the basis of preclusion under Article 3: Case No. 1. Employer signs checks drawn on Employer's account by use of a rubber stamp of Employer's signature. Employer keeps the rubber stamp alone with Employer's personalized blank check forms in an unlocked desk drawer. An unauthorized person fraudulently uses the check forms to write checks on Employer's account. The checks are signed by use of the rubber stamp. If Employer demands that Employer's account in the drawee bank be reaccredited, because the forged check was not properly payable, the drawee bank may defend by asserting that Employer is precluded from asserting the forgery. The trier of fact could find that Employer failed to exercise ordinary care to safeguard the rubber stamp and the check forms and that the failure substantially contributed to the forgery of Employer's signature by the unauthorized use of the rubber stamp. Case No. 2. An insurance company draws a check to the order of Sarah Smith in payment of a claim of a policyholder, Sarah Smith, who lives in Alabama. The insurance company also has a policyholder with the same name who lives in Illinois. By mistake, the insurance company mails the check to the Illinois Sarah Smith, who indorses the check and obtains payment. Because the payee of the check is the Alabama Sarah Smith, the indorsement by the Illinois Sarah Smith is a forged indorsement. The trier of fact could find that the insurance company failed to exercise ordinary care when it mailed the check to the wrong person and that the failure substantially contributed to the making of the forged indorsement. In that event the insurance company could be precluded from asserting the forged indorsement against the drawee bank that honored the check.[6]

What constitutes negligence depends on the circumstances of each case under the U.C.C. section setting forth a comparative negligence test in which losses occasioned by an instrument forgery are allocated between a customer and a bank if each has failed to comply with its respective duties.[7]

Footnotes

1 Official Comment 1 to U.C.C. § 3-406 [2002].

2 U.C.C. § 3-103(a)(9) [2002].

3 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-406:7 (3d ed.).

4 Mercantile Bank of Arkansas v. Vowell, 82 Ark. App. 421, 117 S.W.3d 603, 50 U.C.C. Rep. Serv. 2d 631 (2003). As to what constitutes negligence that "substantially contributes" to an alteration or an unauthorized signature, see § 546.

5 Prestridge v. Bank of Jena, 924 So. 2d 1266, 59 U.C.C. Rep. Serv. 2d 103 (La. Ct. App. 3d Cir. 2006), writ denied, 929 So. 2d 1261 (La. 2006).

6 Official Comment 3 to U.C.C. § 3-406 [2002].

7 Travelers Indem. Co. v. Good, 325 N.J. Super. 16, 737 A.2d 690, 39 U.C.C. Rep. Serv. 2d 625 (App. Div. 1999).

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12 Am. Jur. 2d Bills and Notes § 544

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

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(2) Negligence

§ 544. What constitutes negligence that contributes to alteration of negotiable instrument or forged signature on instrument—Bank

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 365(1), 377, 381

For a payor bank to escape liability under the U.C.C. section setting forth a comparative negligence test in which losses occasioned by instrument forgery are allocated between a customer and a bank if each has failed to comply with its respective duties, a bank must establish that it acted in accordance with reasonable commercial standards and exercised ordinary care.[1] Lack of ordinary care by a bank paying items may be established by proof either that the bank's procedures were below standard or that the bank's employees failed to exercise care in processing items.[2] A bank must use reasonable and proper methods to detect forgeries, but tellers and bookkeepers of a bank are not held to a degree of expertness which a handwriting expert possesses.[3]

Footnotes

[1] Travelers Indem. Co. v. Good, 325 N.J. Super. 16, 737 A.2d 690, 39 U.C.C. Rep. Serv. 2d 625 (App. Div. 1999).
A depositary bank violated reasonable commercial standards by paying checks that drawers' accountant made payable to the state for tax liability and presented for payment to his account as part of a fraudulent scheme; the bank failed to conduct even the most basic of inquiries into whether the checks were in fact presented by an agent of the Commonwealth or deposited to an account of the Commonwealth. Govoni & Sons Const. Co., Inc. v. Mechanics Bank, 51 Mass. App. Ct. 35, 742 N.E.2d 1094, 43 U.C.C. Rep. Serv. 2d 1058 (2001).
As to comparative negligence allocation of loss, see § 548.

[2] Travelers Indem. Co. v. Good, 325 N.J. Super. 16, 737 A.2d 690, 39 U.C.C. Rep. Serv. 2d 625 (App. Div. 1999).
A genuine issue of material fact as to whether a bank violated reasonable commercial standards of fair dealing when it violated known commercial banking practices by accepting checks made payable to a customer into a personal account of the customer's employee, who forged the customer's endorsement, precluded summary judgment in favor of the bank in the customer's action alleging negligence and conversion. Gerber & Gerber, P.C. v. Regions Bank, 266 Ga. App. 8, 596 S.E.2d 174, 52 U.C.C. Rep. Serv. 2d 815 (2004).

[3] Travelers Indem. Co. v. Good, 325 N.J. Super. 16, 737 A.2d 690, 39 U.C.C. Rep. Serv. 2d 625 (App. Div. 1999).

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B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

c. Preclusion of Defense

(2) Negligence

§ 545. Dishonest acts of employee as negligence precluding defenses to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 365(1), 377, 381

Misplaced confidence in an employee will not excuse a depositor from the duty of notifying the bank of alterations on items from the depositor's account. Rather, the depositor is charged with the knowledge of all facts which a reasonable and prudent examination of his or her bank account would have disclosed if made by an honest employee.[1] If a bank can show that an employer's negligence permitted someone to forge or alter an instrument, resulting in loss, and that it acted in good faith in the transaction, the employer will be precluded from asserting the forgery against the bank, but the employer will then have the right to prove that the bank was negligent in handling the transaction, and if it can make this showing, the bank must share the loss to extent its negligence substantially contributed thereto.[2]

A plaintiff may be precluded, on the ground of negligence substantially contributing to the making and acceptance of a forged check, from asserting a claim against a bank which paid on a forged check where the drawer of the forged check is the forger's employer and the employer fails to make basic inquiries into the employee's background.[3]

Footnotes

[1] Menichini v. Grant, 995 F.2d 1224, 20 U.C.C. Rep. Serv. 2d 959 (3d Cir. 1993); Lund v. Chemical Bank, 797 F. Supp. 259, 19 U.C.C. Rep. Serv. 2d 151 (S.D. N.Y. 1992); In re Mid-American Clean Water Systems, Inc., 159 B.R. 941, 22 U.C.C. Rep. Serv. 2d 272 (Bankr. D. Kan. 1993); Husker News Co. v. South Ottumwa Sav. Bank, 482 N.W.2d 404,

19 U.C.C. Rep. Serv. 2d 203 (Iowa 1992).
An advertising agency failed to comply with responsibilities imposed on bank customers by the U.C.C., and thus the agency was not entitled to damages on its strict-liability misrepresentation claim against the bank relating to embezzlement by one of its employees who forged and altered its checks; the agency did not timely examine its bank statements or canceled checks, the agency did not promptly notify the bank of the alleged forgeries and alterations, and the bank paid the checks in good faith. Weber, Leicht, Gohr & Associates v. Liberty Bank, 2000 WI App 249, 239 Wis. 2d 461, 620 N.W.2d 472, 44 U.C.C. Rep. Serv. 2d 794 (Ct. App. 2000).

[2] San Tan Irr. Dist. v. Wells Fargo Bank, 197 Ariz. 193, 3 P.3d 1113, 40 U.C.C. Rep. Serv. 2d 775 (Ct. App. Div. 1 2000).
As to comparative negligence allocation of loss, see § 548.

[3] Webster Soda Fountain Mfg. Corp. v. Chemical Bank, 15 U.C.C. Rep. Serv. 2d 999 (N.Y. Sup 1991).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

c. Preclusion of Defense

(2) Negligence

§ 546. What constitutes negligence that "substantially contributes" to alteration to or unauthorized signature on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 365(1), 377, 381

Treatises and Practice Aids

As to negligence contributing to forged signature or alteration of instrument, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

The U.C.C. refers to a failure to exercise ordinary care that "substantially contributes" to an alteration or to the making of a forged signature.[1] This test is meant to be less stringent than a "direct and proximate cause" test. Under the less stringent test, the preclusion to assert the alteration or forgery should be easier to establish.[2]

In addition to proving that the person in question was negligent by failing to exercise ordinary care, it must be shown that there was a causal relationship between the negligence and the alteration or forgery. The failure to exercise ordinary care must substantially contribute to the making of the alteration or forgery.[3]

Conduct "substantially contributes" to a material alteration or forged signature if it is a contributing cause of the alteration or signature and a substantial factor in bringing it about.[4] The phrase "substantially contributes" indicates a causal relationship and is the equivalent of the substantial factor test applied in the law of negligence, generally.[5] "Substantially contributes"

means a substantial contribution to the forgery rather than that the negligence must be substantial.[6] Therefore, the party seeking to establish negligence does not have to prove gross negligence.[7]

Footnotes

1 U.C.C. § 3-406(a) [2002].

2 Official Comment 2 to U.C.C. § 3-406 [2002].

3 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-406:12 (3d ed.).

4 Official Comment 2 to U.C.C. § 3-406 [2002].

5 Triffin v. American Intern. Group, Inc., 372 N.J. Super. 517, 859 A.2d 751 (App. Div. 2004).
A drawer's negligence leading to the unwarranted issuance of checks will not generally suffice to establish a defense precluding the drawer from asserting alteration or forgery against a person who, in good faith, pays the instrument or takes it for value or for collection; rather the party asserting the preclusion must show some causal relationship between the lack of ordinary care and the actual making of the forged signature, such that the drawer's negligence can be said to have substantially contributed to the ability of the unauthorized person to forge the payee's name and to pose as the intended payee. The Bank/First Citizens Bank v. Citizens and Associates, 82 S.W.3d 259, 48 U.C.C. Rep. Serv. 2d 26 (Tenn. 2002).

6 Travelers Indem. Co. v. Good, 325 N.J. Super. 16, 737 A.2d 690, 39 U.C.C. Rep. Serv. 2d 625 (App. Div. 1999).

7 Dubin v. Hudson County Probation Dept., 267 N.J. Super. 202, 630 A.2d 1207, 22 U.C.C. Rep. Serv. 2d 558 (Law Div. 1993).

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6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

c. Preclusion of Defense

(2) Negligence

§ 547. What does not constitute negligence as to alteration of negotiable instrument or forged signature on instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 365(1), 377, 381

Conduct is not negligent and, therefore, no estoppel arises when the conduct is regarded as being merely laxity in the conduct of business affairs or unbusinesslike.[1] The fact that the name of the payee lacks clarity as to the exact identity of the payee does not give rise to a preclusion.[2] There is no negligence that gives rise to an estoppel in the fact that the drawer fails to supervise the employee who alters the check,[3] the drawer issues the checks at the request of the forger,[4] to the payee's agent,[5] to a person purporting to be the agent or employee of the payee,[6] to an insurance broker,[7] to an attorney,[8] or to the forger,[9] or the blank checks that were forged were stolen from the drawer's premises without his or her knowledge.[10] When a cashier's check is payable to the order of a named person, it is not negligence as a matter of law to mail that check by United States certified mail.[11] A bank is not negligent because it makes a check payable to the order of an "estate" and mails the check to an address other than that of the administrator of the estate.[12]

The mere failure to check apparently valid indorsements does not establish as a matter of law that there was a failure to act in accordance with reasonable commercial standards and it is a question of fact whether a reasonable person would have been put on notice of some impropriety from the form of the instruments, their indorsements, or known facts outside of the instruments.[13] A payee receiving a corporate check from a corporate employee, which check is used by the employee to pay his or her personal debt to the payee, has no duty to inquire of the corporate employer why the check was made payable to the payee.[14]

The fact that a depositor's check protectograph was kept in an unmarked drawer does not constitute negligence with respect to a signature, where the protectograph merely stamped the amount of the check and it was still necessary to add a hand

signature.[15]

Footnotes

1 Federal Deposit Ins. Corp. v. Turner, 869 F.2d 270, 8 U.C.C. Rep. Serv. 2d 1094 (6th Cir. 1989) (holding, however, that laxity will constitute negligence if it is the proximate cause of the loss); Ernst & Co. v. Chemical Bank, 209 A.D.2d 241, 618 N.Y.S.2d 705, 27 U.C.C. Rep. Serv. 2d 240 (1st Dep't 1994).

2 Joffe v. United California Bank, 141 Cal. App. 3d 541, 190 Cal. Rptr. 443, 36 U.C.C. Rep. Serv. 191 (2d Dist. 1983).

3 Hanover Ins. Companies v. Brotherhood State Bank, 482 F. Supp. 501, 28 U.C.C. Rep. Serv. 430 (D. Kan. 1979).

4 Twellman v. Lindell Trust Co., 534 S.W.2d 83, 19 U.C.C. Rep. Serv. 604, 93 A.L.R.3d 943 (Mo. Ct. App. 1976).

5 Society Nat. Bank of Cleveland v. Capital Nat. Bank, 30 Ohio App. 2d 1, 59 Ohio Op. 2d 1, 281 N.E.2d 563, 10 U.C.C. Rep. Serv. 831 (8th Dist. Cuyahoga County 1972).

6 Guaranty Bank & Trust Co. v. Federal Reserve Bank of Kansas City, 454 F. Supp. 488, 24 U.C.C. Rep. Serv. 932 (W.D. Okla. 1977).

7 Guardian Life Ins. Co. of America v. Chemical Bank, 47 A.D.2d 608, 363 N.Y.S.2d 820, 16 U.C.C. Rep. Serv. 786 (1st Dep't 1975).

8 Gast v. American Cas. Co. of Reading, Pa., 99 N.J. Super. 538, 240 A.2d 682, 5 U.C.C. Rep. Serv. 155 (App. Div. 1968); Guardian Life Ins. Co. of America v. Chemical Bank, 47 A.D.2d 608, 363 N.Y.S.2d 820, 16 U.C.C. Rep. Serv. 786 (1st Dep't 1975).
The mere fact that the maker entrusted his note to his attorney did not preclude the maker from asserting as against an ordinary holder the defenses of alteration or unauthorized signature by the attorney. Collins v. Drake, 746 S.W.2d 424, 7 U.C.C. Rep. Serv. 2d 804 (Mo. Ct. App. W.D. 1988).

9 Twellman v. Lindell Trust Co., 534 S.W.2d 83, 19 U.C.C. Rep. Serv. 604, 93 A.L.R.3d 943 (Mo. Ct. App. 1976).

10 Mortimer Agency, Inc. v. Underwriters Trust Co., 73 Misc. 2d 970, 341 N.Y.S.2d 75, 13 U.C.C. Rep. Serv. 270 (N.Y. City Civ. Ct. 1973).

11 Parker v. Dudley, 527 So. 2d 240, 6 U.C.C. Rep. Serv. 2d 149 (Fla. 5th DCA 1988).

12 First Federal Sav. & Loan Ass'n of Hamilton v. Alabama Nat. Bank of Montgomery, 372 So. 2d 350 (Ala. Civ. App. 1979).

13 Inventory Locator Service, Inc. v. Dunn, 776 S.W.2d 523, 10 U.C.C. Rep. Serv. 2d 894 (Tenn. Ct. App. 1989).

14 Hartford Acc. & Indem. Co. v. American Exp. Co., 74 N.Y.2d 153, 544 N.Y.S.2d 573, 542 N.E.2d 1090, 8 U.C.C. Rep. Serv. 2d 865 (1989).

15 Fred Meyer, Inc. v. Temco Metal Products Co., 267 Or. 230, 516 P.2d 80, 13 U.C.C. Rep. Serv. 853 (1973).

12 Am. Jur. 2d Bills and Notes § 548

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

6. Unauthorized Signature; Fraudulent Indorsement; Fictitious Payee; Alteration and Unauthorized Completion

c. Preclusion of Defense

(2) Negligence

§ 548. Comparative negligence allocation of loss as to alteration to or unauthorized signature on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 279, 365(1), 377, 381

Trial Strategy

Bank's Failure to Use Ordinary Care in Detecting Forged or Altered Checks, 13 Am. Jur. Proof of Facts 2d 347 §§ 7 to 15 (Proof of lack of due care of bank in paying altered or forged checks)

If the person asserting that the negligence of another precludes the other from asserting that the instrument was forged failed to exercise ordinary care in paying or taking the instrument and that failure substantially contributed to the loss, the loss is allocated between the person precluded and the person asserting the preclusion according to the extent to which the failure of each to exercise ordinary care contributed to the loss.[1] Even if a drawer is precluded from asserting the entire loss against a depository bank that took checks with a forged endorsement, it could nevertheless seek to shift the burden of the loss to the bank by showing (1) that the bank failed to exercise ordinary care in taking the instruments, and (2) that this failure substantially contributed to the loss.[2] If the customer's failure to exercise ordinary care substantially contributed to the forged signature, then the customer is precluded from asserting the forgery against the bank that pays it in good faith. If, however, the bank's failure to exercise ordinary care substantially contributed to the loss, the loss will be allocated between the two parties.[3]

Comment:

The current version of Article 3 differs from the 1952 version in that it adopts the concept of comparative negligence. If the person precluded from asserting the forgery proves that the person asserting the preclusion failed to exercise ordinary care and that failure substantially contributed to the loss, the loss may be allocated between the two parties on a comparative negligence basis. In the case of a forged indorsement, the litigation is usually between the payee of the check and the depositary bank that took the check for collection. An example would be a case in which the duties of Employee, a bookkeeper, include posting the amounts of checks payable to Employer to the accounts of the drawers of the checks. Employee steals a check payable to Employer, which was entrusted to Employee, and forges Employer's indorsement. The check is deposited by Employee to an account in Depositary Bank which Employee opened in the same name as Employer, and the check is honored by the drawee bank. If Employer brings an action for conversion against the depositary bank that took the check from the forger, the depositary bank could assert the preclusion under Article 3 and, if the trier of fact finds that Employer failed to exercise ordinary care in safeguarding the check and that the failure substantially contributed to the making of the forged indorsement, Employer would be precluded from asserting the forgery. However, suppose the forger opened an account in the depositary bank in a name identical to that of Employer, the payee of the check, and then deposited the check to the account. The comparative negligence provision might apply. There may be an issue whether the depositary bank should have been alerted to possible fraud when a new account was opened for a corporation shortly before a very large check payable to a payee with the same name is deposited. Circumstances surrounding the opening of the account may have suggested that the corporation to which the check was payable may not be the same as the corporation for which the account was opened. If the trier of fact finds that collecting the check under these circumstances was a failure to exercise ordinary care, it could allocate the loss between the depositary bank and Employer, the payee.[4]

Footnotes

1 U.C.C. § 3-406(b) [2002].

2 The Bank/First Citizens Bank v. Citizens and Associates, 82 S.W.3d 259, 48 U.C.C. Rep. Serv. 2d 26 (Tenn. 2002).

3 Chesler v. Dollar Bank, Fed. Sav. Bank, 193 Ohio App. 3d 343, 2011-Ohio-1743, 951 N.E.2d 1098, 74 U.C.C. Rep. Serv. 2d 209 (8th Dist. Cuyahoga County 2011).

4 Official Comment 4 to U.C.C. § 3-406 [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

7. Theft or Loss of Instrument

§ 549. Theft or loss of instrument as defense to action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 382

A.L.R. Library

Rights of one who acquires lost or stolen traveler's checks, 42 A.L.R.3d 846

Loss or theft of a negotiable instrument is not a defense that may be asserted against a holder in due course.[1] The Code, thus, provides that in an action to enforce the obligation of a party to pay the instrument, an obligor is not obliged to pay the instrument if the person seeking enforcement of the instrument does not have the rights of a holder in due course and the obligor proves that the instrument is a lost or stolen instrument.[2]

Comment:

The Code provision allows the issuer of an instrument such as a cashier's check to refuse payment in the rare case in which the issuer can prove that the instrument is a lost or stolen instrument and the person seeking enforcement does not have rights of a holder in due course.[3]

Footnotes

1 Unbank Co. v. Dolphin Temporary Help Services, Inc., 485 N.W.2d 332, 19 U.C.C. Rep. Serv. 2d 810 (Minn. Ct. App. 1992); Dubin v. Hudson County Probation Dept., 267 N.J. Super. 202, 630 A.2d 1207, 22 U.C.C. Rep. Serv. 2d 558 (Law Div. 1993).

2 U.C.C. § 3-305(c) [2002].

3 Official Comment 4 to U.C.C. § 3-305 [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

8. Duress and Mistake

§ 550. Duress as defense to action on negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 104, 374

A.L.R. Library

Duress, Incapacity, Illegality, or Similar Defense Rendering Obligation a Nullity as Affecting Enforceability of Negotiable Instrument Against Holder in Due Course Under U.C.C. [rev] s3-305(a)(1)(ii), 89 A.L.R.5th 577

Economic duress or business compulsion in execution of promissory note, 79 A.L.R.3d 598

Ratification of contract voidable for duress, 77 A.L.R.2d 426

Trial Strategy

Promissory Note Executed Under Economic Duress or Business Compulsion, 11 Am. Jur. Proof of Facts 2d 23 §§ 14 to 27 (Proof that promissory note was executed under economic duress or business compulsion)

Except as otherwise provided, the right to enforce the obligation of a party to pay an instrument is subject to a defense of the obligor based on duress, which, under other law, nullifies the obligation of the obligor.[1] The right of a holder in due course to enforce the obligation of a party to pay an instrument is also subject to a defense of duress, which, under other law, nullifies the obligation of the obligor.[2]

Comment:

Duress, as that term is used here, is a matter of degree. For example, an instrument signed at the point of a gun is void even in the hands of a holder in due course. However, one signed under threat to prosecute the son of the maker for theft may be merely voidable, so the defense is cut off. In other words, if the effect of the particular duress is to make the obligation entirely null and void, the defense may be asserted against a holder in due course. Otherwise it is cut off.[3]

To constitute duress, there must be such compulsion as to show that the paper was not executed as a voluntary act,[4] and the act of the party compelling obedience of another must itself be unlawful or wrongful.[5]

A threat to exercise a legal right does not constitute duress.[6] A party does not sign a note under duress when the party does so to avoid a lawsuit which the party fears he or she would lose.[7]

No duress is present when a creditor states that he or she will pursue a particular remedy which the law provides and a party signs a note in order to prevent that.[8] Thus, a threat to enforce a valid claim held against a maker if he or she does not execute a note to cover a different obligation does not constitute duress.[9]

Also, it is not duress for a holder to threaten to sue on a promissory note as the holder has the right to do so.[10]

The refusal of a creditor to release a lien until he or she is given a promissory note for the amount of the claim is not improper and does not constitute duress so as to avoid liability on the note.[11]

The fact that a note is signed to keep a close relative from going into bankruptcy, because of a possible harmful effect on his or her business, future does not constitute duress.[12]

Duress in obtaining the execution of a note is waived by voluntary renewals and payments on the note by the maker extending over a period of several years.[13] Moreover, one who would repudiate a voidable contract obtained by duress must act promptly or he or she will be deemed to have elected to affirm it.[14]

Observation:

Negotiation is effective to transfer an instrument even if obtained by duress. However, to the extent permitted by other law, such negotiation may be rescinded or may be subject to other remedies, but those remedies may not be asserted against a subsequent holder in due course or a person paying the instrument in good faith and without knowledge of the facts that are the basis for rescission or other remedy.[15]

Footnotes

1 U.C.C. § 3-305(a)(1)(ii) [2002].
As to the effect of duress on contracts, generally, see Am. Jur. 2d, Contracts § 212.

2 U.C.C. § 3-305(b) [2002].

[3] Official Comment 1 to U.C.C. § 3-305 [2002].

[4] First Sec. Bank of Glendale Heights v. Bawoll, 120 Ill. App. 3d 787, 76 Ill. Dec. 54, 458 N.E.2d 193 (2d Dist. 1983).

[5] Sulner v. Traver, 75 A.D.2d 616, 427 N.Y.S.2d 58 (2d Dep't 1980).

[6] Marine Midland Bank, N.A. v. Hallman's Budget Rent-A-Car of Rochester, Inc., 204 A.D.2d 1007, 613 N.Y.S.2d 92 (4th Dep't 1994).

[7] Gooding v. Millet, 517 So. 2d 396 (La. Ct. App. 5th Cir. 1987).

[8] Norris v. Stewart, 350 So. 2d 31 (Fla. 1st DCA 1977).

[9] Marine Midland Bank v. Stukey, 75 A.D.2d 713, 427 N.Y.S.2d 123 (4th Dep't 1980), order aff'd, 55 N.Y.2d 633, 446 N.Y.S.2d 265, 430 N.E.2d 1318 (1981).

[10] Avco Financial Services v. Foreman-Donovan, 237 Mont. 260, 772 P.2d 862 (1989); Helena Chemical Co. v. Rivenbark, 45 N.C. App. 517, 263 S.E.2d 305 (1980).

[11] Richardson v. Office Bldgs. of Houston, 704 S.W.2d 373 (Tex. App. Houston 14th Dist. 1985).

[12] Wiesen v. Short, 43 Colo. App. 374, 604 P.2d 1191 (App. 1979).

[13] Greenpoint Nat. Bank of Brooklyn v. Gilbert, 237 N.Y. 19, 142 N.E. 338 (1923).
As to the waiver of defenses, generally, see § 502.

[14] Port Chester Elec. Const. Corp. v. Hastings Terraces, 284 A.D. 966, 134 N.Y.S.2d 656 (2d Dep't 1954).

[15] § 188.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

8. Duress and Mistake

§ 551. Economic duress or business compulsion as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 104, 374

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Duress, Incapacity, Illegality, or Similar Defense Rendering Obligation a Nullity as Affecting Enforceability of Negotiable Instrument Against Holder in Due Course Under U.C.C. [rev] s3-305(a)(1)(ii), 89 A.L.R.5th 577

Economic duress or business compulsion in execution of promissory note, 79 A.L.R.3d 598

Economic duress or business compulsion is a defense available to the maker against the payee.[1] It is essential to constitute economic duress that there is a threat of conduct, such as a breach of contract, and that the threat comes from the obligee seeking to enforce the obligation and not from a third person.[2]

The defense of business duress or compulsion ordinarily cannot be sustained upon proof of a demand which is lawful, or upon doing or threatening to do that which a party has a legal right to do; business duress is not established merely by proof that consent was secured by the pressure of financial circumstances.[3]

Also, the existence of financial pressure combined with unequal bargaining position is insufficient to constitute economic duress.[4]

Economic duress is not established by the fact that—
— a party signs a note, because of the force of his or her circumstances for which the other party is not responsible.[5]
— a party is in a weak bargaining position and is under financial pressure.[6]

— after a judgment creditor executed upon the business of the debtor another substantial creditor gave the judgment creditor a note for the amount due, particularly when the note was signed after substantial negotiation and the payee had not made any threats of any kind.[7]
— a note is signed to keep a brother from going into bankruptcy, because of a possible harmful effect on his business future.[8]
— a threat is made by the payee to whom a note is given that he will do his best to interfere with a business transaction if he is not paid his price.[9]
— the seller makes it clear that he or she will forfeit the buyer's earnest money if the buyer does not complete the purchase of land.[10]
— the signer has a subjective belief that she was pressured into signing a document, when the action of the signer was, in fact, voluntary.[11]
— a mere threat is made to break a contract, unless a promissory note is signed, unless facts are established that show that a breach would subject the victim to irreparable harm.[12]
— a lender threatens to commence legal proceedings to collect the debt owed to the lender.[13]

Observation:

Negotiation is effective to transfer an instrument even if obtained by duress. However, to the extent permitted by other law, such negotiation may be rescinded or may be subject to other remedies, but those remedies may not be asserted against a subsequent holder in due course or a person paying the instrument in good faith and without knowledge of the facts that are the basis for rescission or other remedy.[14]

Footnotes

1 Gerber v. First Nat. Bank of Lincolnwood, 30 Ill. App. 3d 776, 332 N.E.2d 615, 17 U.C.C. Rep. Serv. 1072, 79 A.L.R.3d 592 (1st Dist. 1975); Gelb v. Bucknell Press, Inc., 69 A.D.2d 829, 415 N.Y.S.2d 89 (2d Dep't 1979); Mancino v. Friedman, 69 Ohio App. 2d 30, 23 Ohio Op. 3d 27, 429 N.E.2d 1181 (8th Dist. Cuyahoga County 1980); Avco Financial Services, Inc. v. Johnson, 596 P.2d 658 (Utah 1979).

2 Edison Stone Corp. v. 42nd Street Development Corp., 145 A.D.2d 249, 538 N.Y.S.2d 249 (1st Dep't 1989).
The defense of economic duress requires proof of an unlawful or wrongful act that is sufficiently coercive to cause a reasonable prudent person faced with no reasonable alternative to succumb to the pressure. First Nat. Bank and Trust Co. of Vinita v. Kissee, 1993 OK 96, 859 P.2d 502 (Okla. 1993).

3 Aldrich & Co. v. Donovan, 238 Mont. 431, 778 P.2d 397 (1989); Star Bank, N.A., Cincinnati v. Management Technologies, Inc., 69 Ohio App. 3d 147, 590 N.E.2d 298 (1st Dist. Hamilton County 1990).

4 Edison Stone Corp. v. 42nd Street Development Corp., 145 A.D.2d 249, 538 N.Y.S.2d 249 (1st Dep't 1989).

5 Avco Financial Services v. Foreman-Donovan, 237 Mont. 260, 772 P.2d 862 (1989).

6 Edison Stone Corp. v. 42nd Street Development Corp., 145 A.D.2d 249, 538 N.Y.S.2d 249 (1st Dep't 1989).

7 Mitchell v. Rothwell, 92 N.C. App. 460, 374 S.E.2d 627 (1988).

8 Wiesen v. Short, 43 Colo. App. 374, 604 P.2d 1191 (App. 1979).

9 Smith v. Lenchner, 204 Pa. Super. 500, 205 A.2d 626, 2 U.C.C. Rep. Serv. 436 (1964) (holding, however, that the instrument was nonnegotiable, because a confession of judgment at any term was authorized).

10 Anziano v. Appalachee Enterprises, Inc., 208 Ga. App. 760, 432 S.E.2d 117 (1993).

[11] F.D.I.C. v. Rusconi, 808 F. Supp. 30 (D. Me. 1992).

[12] Sosnoff v. Carter, 165 A.D.2d 486, 568 N.Y.S.2d 43 (1st Dep't 1991).

[13] Resolution Trust Corp. v. Palmetto Fort of Mt. Pleasant, 831 F. Supp. 510 (D.S.C. 1993).

[14] § 188.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

8. Duress and Mistake

§ 552. Mistake as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 102, 372

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Right of bank certifying check or note by mistake to cancel, or avoid effect of, certification, 25 A.L.R.3d 1367

Forms

Forms relating to mistake, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

As to a person other than a holder in due course, the right to enforce the obligation of a party to pay a negotiable instrument is subject to a defense of the obligor that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract.[1] Mistake is among these defenses.[2]

Footnotes

[1] U.C.C. § 3-305(a)(2) [2002].

[2] Official Comment 2 to U.C.C. § 3-305 [2002].
As to the effect of mistake on a contract, see Am. Jur. 2d, Contracts §§ 197 to 208.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

9. Discharge

§ 553. Discharge of negotiable instrument in insolvency proceedings as defense to action on instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 383, 437

Forms

Forms relating to discharge in bankruptcy, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Forms relating to defenses against holder in due course, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Except as otherwise provided, the right to enforce the obligation of a party to pay an instrument is subject to a defense of the obligor based on discharge of the obligor in insolvency proceedings.[1]

Comment:

The Code specifically states that the defense of discharge in insolvency proceedings is not cut off when the instrument is purchased by a holder in due course.[2]

Insolvency proceedings include any assignment for the benefit of creditors or other proceedings intended to liquidate or rehabilitate the estate of the person involved.[3] The reference to insolvency proceedings in Revised Article 3 includes bankruptcy whether or not the debtor is insolvent.[4]

Footnotes

1 U.C.C. § 3-305(a)(1)(iv) [2002].

2 Official Comment 1 to U.C.C. § 3-305 [2002].
As to a defense based on a discharge other than in insolvency proceedings, see § 554.

3 U.C.C. § 1-201(b)(22)[2001].

4 Official Comment 1 to U.C.C. § 3-305 [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

9. Discharge

§ 554. Discharge of negotiable instrument other than in insolvency proceedings as defense to action on instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 383, 436 to 440

Forms

Forms relating to defense of payment, generally, see Am. Jur. Pleading and Practice Forms, Bills and Notes [Westlaw®(r): Search Query]

Forms relating to discharge and payment of note, generally, see Am. Jur. Pleading and Practice Forms, Commercial Code [Westlaw®(r) Search Query]

Revised Article 3 does not express discharge as a defense, and does not include it in the Code provision that, except as to a holder in due course, the right to enforce the obligation of a party to pay a negotiable instrument is subject to a defense of the obligor stated in Revised Article 3.[1] The obligation of a party to pay the instrument is discharged as stated in Article 3 or by an act or agreement with the party which would discharge an obligation to pay money under a simple contract.[2] On the other hand, the Code does provide that a discharge of the obligation of a party is not effective against a person acquiring the rights of a holder in due course of the instrument without notice of the discharge.[3] The Code also reiterates this principle by providing that notice of discharge of a party, other than discharge in an insolvency proceeding, is not notice of a defense, but discharge is effective against a person who became a holder in due course with notice of the discharge.[4]

When an instrument is paid in whole or in part before maturity, it is the duty of the party making payment to have the payment indorsed or to require surrender of the instrument, and if such party omits these precautions and the instrument is transferred before maturity to a holder in due course without notice of the payments, the party that made payment may not avail himself or herself of the defense of prior payment against such a holder.[5] A promissory note as a negotiable instrument,

thus, entitles a holder in due course to payment, irrespective of the payor's claim that he or she has discharged any obligation by payment to someone else.[6]

If there is payment to the holder or the holder's authorized agent which discharges in whole or in part the obligation of a negotiable instrument, such payment is a defense against the holder to whom or to whose authorized agent the payment was made, or against a subsequent holder who does not have the rights of a holder in due course, including one who takes the instrument after maturity without notice of a prior payment.[7]

A former holder who reacquires an instrument may cancel indorsements made after the reacquirer first became a holder of the instrument. An indorser whose indorsement is canceled is discharged and the discharge is effective against any subsequent holder.[8]

Footnotes

1 Official Comment 3 to U.C.C. § 3-302 [2002], referring to U.C.C. § 3-305(a)(2) [2002].

2 U.C.C. § 3-601(b) [2002].

3 U.C.C. § 3-601(b) [2002].
As to the rights of a holder in due course, generally, see § 214.
As to a discharge in insolvency being a defense against a holder in due course, see § 553.

4 U.C.C. § 3-302(b) [2002].

5 Ehrlich v. Jennings, 78 S.C. 269, 58 S.E. 922 (1907); Perkins v. Hall, 123 W. Va. 707, 17 S.E.2d 795 (1941).

6 International Center of The Americas, Inc. v. Chemical Bank, 384 So. 2d 725, 29 U.C.C. Rep. Serv. 920 (Fla. 3d DCA 1980).

7 Bank of Willard v. Pennsylvania & Kentucky Fire Brick Co., 175 Ky. 192, 194 S.W. 110 (1917); Mansfield v. Wade, 208 N.C. 790, 182 S.E. 475 (1935); Clayton v. Read House Co., 24 Tenn. App. 149, 141 S.W.2d 916 (1939).

8 U.C.C. § 3-207 [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

10. Other Defenses

§ 555. Failure to countersign negotiable instrument as defense to action on instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 58, 368

If a negotiable instrument requires, as a condition to payment, a countersignature by a person whose specimen signature appears on the instrument, the failure of that person to countersign the instrument is a defense to the obligation of the issuer.[1]

Observation:

This Uniform Commercial Code provision applies to traveler's checks or other instruments that may require a countersignature. Suppose a thief steals a traveler's check and cashes it by skillfully imitating the specimen signature so that the countersignature appears to be authentic. The countersignature is for the purpose of identification of the owner of the instrument. It is not an indorsement. This provision provides that the failure of the owner to countersign does not prevent a transferee from becoming a holder. Thus, the merchant or bank that cashed the traveler's check becomes a holder when the traveler's check is taken. The forged countersignature is a defense to the obligation of the issuer to pay the instrument, but this defense may not be asserted against a holder in due course. Whether a holder has notice of the defense is a factual question. If the countersignature is a very bad forgery, there may be notice. However, if the merchant or bank cashed a traveler's check and the countersignature appeared to be similar to the specimen signature, there might not be notice that the countersignature was forged. Thus, the merchant or bank could be a holder in due course.[2]

Footnotes

[1] U.C.C. § 3-106(c) [2002].

[2] Official Comment 2 to U.C.C. § 3-106 [2002].
As to traveler's checks as negotiable instruments, see § 33.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

10. Other Defenses

§ 556. Rescission of negotiation of negotiable instrument as defense to action on instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 228, 365(1)

Treatises and Practice Aids

As to persons subject to avoidance of negotiation, see Lawrence's Anderson on the Uniform Commercial Code, Article 3 [Rev] Negotiable Instruments [Westlaw®(r): Search Query]

To the extent permitted by other law, the negotiation of an instrument may be rescinded or may be subject to other remedies, but those remedies may not be asserted against a subsequent holder in due course or a person paying the instrument in good faith and without knowledge of facts that are a basis for rescission or other remedy.[1] Negotiation may be rescinded as against a person not having the rights of a holder in due course and against a payor who fails to act in good faith.[2] A negotiation may not be rescinded when the instrument is held by a holder in due course. By virtue of the shelter rule, a transferee from a holder in due course obtains the same protection against rescission of a negotiation as its transferor.[3] Similarly, a negotiation may not be rescinded as against a person paying the instrument in good faith and without knowledge of facts constituting the basis for the rescission.[4] A payor who pays the instrument in good faith and without knowledge of the facts on which the rescission (or any other remedy) would be based is not subject to the defense that a negotiation in the chain was avoidable.[5]

Footnotes

1 U.C.C. § 3-202(b) [2002].

[2] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-202:5 (3d ed.).

[3] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-202:6 (3d ed.).

[4] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-202:6 (3d ed.).

[5] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-202:7 (3d ed.).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

10. Other Defenses

§ 557. Modification of obligation on negotiable instrument by separate agreement as defense to action on instrument

Topic Summary | Correlation Table | References

West's Key Number Digest
West's Key Number Digest, Bills and Notes 136

Article 3 of the Uniform Commercial Code provides that, subject to the applicable law regarding exclusion of proof of contemporaneous or previous agreements, the obligation of a party to an instrument to pay the instrument may be modified, supplemented, or nullified by a separate agreement of the obligor and a person entitled to enforce the instrument, if the instrument is issued or the obligation is incurred in reliance on the agreement or as part of the same transaction giving rise to the agreement.[1] To the extent any obligation of a party to an instrument to pay the instrument is modified, supplemented, or nullified by an agreement under the Code, the agreement is a defense to the obligation.[2]

Comment:

A person might be induced to sign an instrument under an agreement that the signer will not be liable on the instrument, unless certain conditions are met. Suppose X requested credit from Creditor, who is willing to give the credit only if an acceptable accommodation party will sign the note of X as comaker. Y agrees to sign as comaker on the condition that Creditor also obtain the signature of Z as comaker. Creditor agrees and Y signs as comaker with X. Creditor fails to obtain the signature of Z on the note. While Y would ordinarily be obliged to pay the note, the agreement modifies the terms of the note by stating a condition to the obligation of Y to pay the note. This case is essentially similar to a case in which a maker of a note is induced to sign the note by fraud of the holder. Although the agreement that Y not be liable on the note, unless Z also signs may not have been fraudulently made, a subsequent attempt by Creditor to require Y to pay the note in violation of the agreement is a bad faith act. Article 3, in treating the agreement as a defense, allows Y to assert the agreement against Creditor, but the defense would not be good against a subsequent holder in due course of the note that took it without notice of the agreement. If there cannot be a holder in due course under the Code, a subsequent holder that took the note in good faith, for value and without knowledge of the agreement would not be able to enforce the liability of Y. This result is consistent with the risk that a holder not in due course takes with respect to fraud in inducing issuance of an instrument.[3]

Any agreement admissible under this section is a defense available against any person other than a holder in due course without notice of the agreement. Evidence of an agreement admissible under this section is admissible against a holder in due course who had notice of the agreement when he or she took the instrument.[4] Even when an agreement is executed as part of the same transaction, its performance might not be a condition to the payment of the instrument. If it is not, failure to perform the agreement will not be a defense to payment of the instrument.[5]

Footnotes

1 § 113.

2 U.C.C. § 3-117 [2002].

3 Official Comment 1 to U.C.C. § 3-117 [2002].

4 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-117:7 (3d ed.).

5 Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-117:7 (3d ed.).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

10. Other Defenses

§ 558. Payment that violates restrictive indorsement as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 174, 383

The provision in Revised Article 3 governing restrictive indorsements states that, in an action to enforce the obligation of a party to pay an instrument, the obligor has a defense if payment would violate an indorsement to which the statute applies and the payment is not permitted by the statute.[1]

Comment:

This provision allows a restrictive indorsement to be used as a defense by a person obliged to pay the instrument if that person would be liable for paying in violation of the indorsement.[2]

The fact that a restrictive indorsement cannot be read, because it was stamped and the stamping smeared, does not free the indorsee from its terms, as inquiry would have led to full disclosure of those terms.[3]

Footnotes

[1] U.C.C. § 3-206(f) [2002].

[2] Official Comment 5 to U.C.C. § 3-206 [2002].

[3] Larry's Mobile Homes, Inc. v. Robins Federal Credit Union, 161 Ga. App. 822, 288 S.E.2d 800 (1982).

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B. Particular Defenses

10. Other Defenses

§ 559. Breach of warranty as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 296, 326

If a drawee accepts a draft as to which the person obtaining acceptance makes the specified warranties, breach of warranty is a defense to the obligation of the acceptor.[1]

Comment:

With respect to presentment of an accepted draft to the acceptor, there is no warranty with respect to alteration or knowledge that the signature of the drawer is unauthorized. Those warranties were made to the drawee when the draft was presented for acceptance, and breach of that warranty is a defense to the obligation of the drawee as acceptor to pay the draft.[2]

Footnotes

1 U.C.C. § 3-417(b) [2002].

2 Official Comment 4 to U.C.C. § 3-417 [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

B. Particular Defenses

10. Other Defenses

§ 560. Defense outside making of note and obligations thereunder as defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 365(1), 452(1)

The breach of a related contract is generally not a defense to nonpayment of an instrument for money only, but where the note and the contract are inextricably intertwined as part of the same transaction, a breach of the related contract may create a defense to payment on the note.[1] A defense outside the making of a note and the obligations thereunder, separate from the borrower's unequivocal and unconditional obligation to repay monies under the note, and thus is not a defense against lender on its claim to recover on the promissory note.[2]

A lender's alleged failure to comply with federal regulations is generally not an affirmative defense to the lender's action against the borrower to enforce a promissory note.[3]

Footnotes

1 Fitzpatrick v. Animal Care Hosp., PLLC, 104 A.D.3d 1078, 962 N.Y.S.2d 474 (3d Dep't 2013).

2 German American Capital Corp. v. Oxley Development Co., LLC, 102 A.D.3d 408, 958 N.Y.S.2d 49 (1st Dep't 2013) (also noting that to the extent that such a defense amounts to viable claim it can be asserted in a separate action).

3 Myers v. First Citizens Bank & Trust Co., 324 Ga. App. 293, 750 S.E.2d 378 (2013).

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

C. Claims in Recoupment and Claims to Instrument

Topic Summary | Correlation Table

Research References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 315, 363, 365(1), 451(1), 451(2)

A.L.R. Library

A.L.R. Index, Bills and Notes
A.L.R. Index, Checks and Drafts
A.L.R. Index, Counterclaim and Setoff
A.L.R. Index, Uniform Commercial Code
West's A.L.R. Digest, Bills and Notes 315, 363, 365(1), 451(1), 452(2)

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

C. Claims in Recoupment and Claims to Instrument

1. Claims in Recoupment

§ 561. Claims in recoupment as affecting obligation of party to pay a negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 451(1), 451(2)

Except as otherwise provided, the right to enforce the obligation of a party to pay an instrument is subject to a claim in recoupment of the obligor against the original payee of the instrument if the claim arose from the transaction that gave rise to the instrument.[1]

Comment:

Under current judicial authority and non-Uniform Commercial Code statutory law, there will be many cases in which a transferee of a note arising from a sale transaction will not qualify as a holder in due course. For example, applicable law may require the use of a note to which there cannot be a holder in due course. It is reasonable to provide that the buyer should not be denied the right to assert claims arising out of the sale transaction, but it is not reasonable to require the transferee to bear the risk that wholly unrelated claims may also be asserted.[2] The determination of whether a claim arose from the transaction that gave rise to the instrument is determined by law other than Article 3, and thus may vary as local law varies.[3]

The assertion of claims in recoupment is subject to additional limitations. Only certain claims may be asserted against a holder in due course,[4] and a claim in recoupment against the original payee may be asserted against a transferee of the instrument only to reduce the amount owing on the instrument at the time the action is brought.[5]

Footnotes

1 U.C.C. § 3-305(a)(3) [2002].
As to the distinction between a claim in recoupment and a defense, see § 562.

2 Official Comment 3 to U.C.C. § 3-305 [2002].

3 Official Comment 3 to U.C.C. § 3-305 [2002].

4 § 563.

5 § 564.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

C. Claims in Recoupment and Claims to Instrument

1. Claims in Recoupment

§ 562. Distinction between claim in recoupment and defense to action on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 451(1), 451(2)

The Uniform Commercial Code makes a distinction between defenses to the obligation to pay a negotiable instrument and claims in recoupment by the maker or drawer that may be asserted to reduce the amount payable on the instrument.[1]

Comment:

The distinction between a claim in recoupment and a defense is illustrated by the following example: Buyer issues a note to the order of Seller in exchange for a promise of Seller to deliver specified equipment. If Seller fails to deliver the equipment or delivers equipment that is rightfully rejected, Buyer has a defense to the note, because the performance that was the consideration for the note was not rendered. However, suppose Seller delivered the promised equipment and it was accepted by Buyer. The equipment, however, was defective. Buyer retained the equipment and incurred expenses with respect to its repair. In this case, Buyer does not have a defense of nonperformance of consideration: Seller delivered the equipment, the equipment was accepted, and Buyer is obliged to pay the price of the equipment which is represented by the note. However, Buyer may have a claim against Seller for breach of warranty, which may be asserted against Seller as a claim in recoupment to reduce the amount owing on the note. If Seller negotiates the note to Holder and Holder had notice of Buyer's warranty claim at the time the note was negotiated, Holder is not a holder in due course and Buyer may assert the claim against Holder but only as a claim in recoupment.[2]

Footnotes

[1] Official Comment 2 to U.C.C. § 3-302 [2002], referring to U.C.C. § 3-305(a) [2002].

[2] Official Comment 3 to U.C.C. § 3-305 [2002].
As to when a claim in recoupment may be asserted against a holder in due course, see § 563.

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

C. Claims in Recoupment and Claims to Instrument

1. Claims in Recoupment

§ 563. Assertion of claim of recoupment against holder in due course

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 365(1)

Under pre-Code law, where a negotiable instrument or bill of exchange was transferred in good faith, and on good consideration, before maturity, the holder was not subject to any setoff existing against any prior party.[1] The Uniform Commercial Code retains this rule, but permits a claim in recoupment to be asserted against a holder in due course if the claim is against the holder; specifically, the Code provides that the right of a holder in due course to enforce the obligation of a party to pay the instrument is not subject to claims in recoupment against a person other than the holder.[2]

Comment:

It is not relevant whether Seller is or is not a holder in due course of the note or whether Seller knew or had notice that Buyer had the warranty claim. It is obvious the holder in due course doctrine cannot be used to allow Seller to cut off a warranty claim that Buyer has against Seller, and the above Code provision specifically covers this point by stating that a holder in due course is not subject to a claim in recoupment against a person other than the holder. However, if Seller negotiates the note to Holder, and Holder had no notice of Buyer's claim and otherwise qualifies as a holder in due course, Buyer may not assert the claim against Holder.[3]

Footnotes

[1] McKenney v. Ellsworth, 165 Cal. 326, 132 P. 75 (1913).

[2] U.C.C. § 3-305(b) [2002].

[3] Official Comment 3 to U.C.C. § 3-305 [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

C. Claims in Recoupment and Claims to Instrument

1. Claims in Recoupment

§ 564. Claim of recoupment as assertable only to reduce amount owing on negotiable instrument

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 451(1), 451(2)

A claim in recoupment of the obligor against the original payee of a negotiable instrument may be asserted against a transferee of the instrument only to reduce the amount owing on the instrument at the time the action is brought.[1]

Comment:

If the warranty claim is more than the unpaid amount of the instrument, the buyer owes nothing to the holder, but the buyer cannot recover the unpaid amount of the claim from the holder. If the buyer has already partially paid the instrument, the buyer is not entitled to recover the amount paid. The claim can be used only as an offset to the amount owing on the instrument.[2]

Footnotes

1 U.C.C. § 3-305(a)(3) [2002].

2 Official Comment 3 to U.C.C. § 3-305 [2002].

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XII. Defenses, Claims in Recoupment, and Related Claims or Grounds for Relief

C. Claims in Recoupment and Claims to Instrument

2. Claims to an Instrument

§ 565. Claims to a negotiable instrument, generally

Topic Summary | Correlation Table | References

West's Key Number Digest

West's Key Number Digest, Bills and Notes 315, 363, 451(1)

A person taking an instrument, other than a person having the rights of a holder in due course, is subject to a claim of a property or possessory right in the instrument or its proceeds, including a claim to rescind a negotiation and to recover the instrument or its proceeds. A person having the rights of a holder in due course takes free of the claim to the instrument.[1]

Comment:

Claims covered by this section include not only claims to ownership, but also any other claim of a property or possessory right. It includes the claim to a lien or the claim of a person in rightful possession of an instrument who was wrongfully deprived of possession. Also included is a claim for rescission of a negotiation of the instrument by the claimant. Claims to an instrument are different from claims in recoupment referred to elsewhere in Article 3.[2]

The Code does not affect non-Code judicial procedure so that the practice governing the joinder of plaintiffs in the alternative and interpleader may often be resorted to in order to obtain a judicial determination as to the validity of a claim to an instrument or its proceeds.[3]

If a bank is on notice of another claim,[4] or of potential foul play,[5] it does not qualify as a holder in due course.

Footnotes

[1] U.C.C. § 3-306 [2002].
As to rights of a holder in due course, see § 232.

[2] Official Comment to U.C.C. § 3-306 [2002], referring to U.C.C. § 3-202(b) [2002], with respect to claims for rescission, and to U.C.C. § 3-305(a)(3) [2002], with respect to claims in recoupment.

[3] Frisch, Lawrence's Anderson on the Uniform Commercial Code § 3-306:5 (3d ed.).

[4] Provident Bank v. MorEquity, Inc., 262 Ga. App. 331, 585 S.E.2d 625, 50 U.C.C. Rep. Serv. 2d 1205 (2003).

[5] Mutual Service Cas. Ins. Co. v. Elizabeth State Bank, 265 F.3d 601, 45 U.C.C. Rep. Serv. 2d 281 (7th Cir. 2001).

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